

**Access to Microfinance & Improved Implementation of Policy
Reform
(AMIR Program)**

Funded By U.S. Agency for International Development

**ALTERNATIVE FUNDING FACILITY
FOR MICROFINANCE INSTITUTIONS IN JORDAN**

Final Report

**Deliverable for SMI Component, Task No. 3.1.5
Contract No. 278-C-00-98-00029-00**

March, 2000

This report was prepared by Graham Perrett, in collaboration with Chemonics International Inc., prime contractor to the U.S. Agency for International Development for the AMIR Program in Jordan.

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EXECUTIVE SUMMARY:

As required by the Scope of Work (SOW), the consultant spent approximately 41 days in country, undertaking an options study and the preparation of a business plan, for the establishment of an Alternative Funding Facility (the Facility). The main findings of the survey and business plan are as follows:

1. There is a clear need for a funding Facility. While it is difficult to quantify the exact loan demand from the Facility due to incomplete demand surveys and stale business plans, a likely range will be 4,000,000-10,000,000 JD. Borrowing needs from the Facility by the MFIs is projected to commence during the second half of calendar year 2000.
2. The Facility has been designed to provide financial services to the existing four Microfinance Institutions (MFIs), all of whom have expressed interest in using it as a funding source. Additionally, provision has been made for up to two of the other lenders to microfinance businesses to have access to the Facility, of which only one would be using it at any time.
3. Various legal structures for the Facility were explored. Of the three readily available alternatives, establishing the Facility as a Limited Liability Company is the most appropriate legal vehicle. This is because of its low cost and ease of registration, the transparency of its operations, its clear reporting requirements, and the fact that local entities without overseas operations would be able to effectively manage it.
4. A variety of managerial frameworks were considered, and the approach of sub-contracting the management of the Facility to an existing financial institution is the recommended course. Moreover, a number of financial organizations have been contacted, and to date four have expressed interest in managing the Facility.
5. During discussions with potential managers, two forms of management contracts were posited. The first alternative was that the Manager would administer the Facility according to a strict set of directives, and as long as these directives were followed, the Manager would not be accountable for any losses. The second alternative would give the Manager considerable latitude in managing the Facility but would require them to absorb a portion of any losses that were incurred. A large majority of recipients seem to prefer the risk free administrative approach.
6. Several methodologies for establishing the interest rate to be charged on loans by the Facility were considered. Of the various alternatives the Central Bank of Jordan's re-

discount rate (currently 8.5%) is considered to be the most appropriate. To this benchmark various spreads are to be added, which will vary in accordance with the type of loan and the perceived creditworthiness of the borrower.

7. Under the business plan, a variety of projections and sensitivity analysis were undertaken. If the Facility is grant funded, thereby incurring no “real” cost of capital, the Facility is highly profitable and achieves break-even in the second year of its operations. Because of the high level of re-invested earnings, the amount of funding needed to finance the expected use of the Facility is a lot less than what is needed if the subscribed capital carries a cost. For example, on a no-cost basis, the granted capital over a five year period required to fund a loan portfolio of 11,100,000 JD will be approximately 2,750,000 JD less than the case where the subscribed capital is costed at 8.25% per annum. The approach on this issue that is adopted has a major bearing on both the structure and size of the capital of the Facility.
8. The structure of the capital of the Facility also heavily impacts the operational sustainability of the Facility. If the Facility is grant funded, thereby incurring no cost of capital, the Facility becomes profitable in the second year, and could become highly profitable thereafter. On the other hand, though, if a cost of capital equal to the interest rate paid by the Central Bank of Jordan on its 6 month Certificates of Deposits (8.25%) is paid on the subscribed capital, the Facility breaks-even in year 4 and is only moderately profitable thereafter.
9. A critical issue that needs to be resolved as soon as possible is the funding of the Facility. As originally outlined, USAID was to provide the start-up funding. But the certainty of this source now seems, at best, subject to delay. If the decision is made to go ahead with the establishment of the Facility, it is strongly recommended that clarifying and quantifying the funding for the Facility be given the highest priority.
10. A review of the Jordan Loan Guarantee Corporation (JLGC) was undertaken, as required by the SOW. The conclusions are that they do not represent the best choice to undertake the role and responsibilities as the manager of the Facility at this stage. They do, however, have a potentially important role to play in providing loan guarantees to either the Facility itself, or to the MFIs directly.
11. Included in the report as part of the deliverables are the following;
 - A recommended legal structure
 - A recommended management structure
 - A list of potential clients
 - A short list of potential managers
 - An outline of the Roles and Responsibilities for the Manager

- An outline of the Terms and Conditions of the Management Contract.
- Proposed Loan Products for the Facility
- Proposed Pricing Structure for the Loan Products
- An Operating Structure for the Facility.
- Credit Criteria for Borrowers
- Credit Incentives to Encourage Good Credit Performance by Borrowers
- Reporting Formats for the MFIs to prepare for the Facility Manager.
- Compliance and Audit Criteria
- A Projected Business Plan
- A five year projection model
- Reporting outlines for the Facility to report to AMIR.
- Next Steps

In conclusion, there is clear enthusiasm, and need, for the Facility by the MFIs, and its creation is strongly encouraged. The report contains various alternatives for its creation, and recommends what appears to be the most time and cost effective approach to establish the Facility. A short list of potential Managers has been identified, and basic terms and conditions of their management contract have been included. There are included projection models, and proposed reporting formats, for use in establishing and managing the Facility, all of which should assist a fast start-up. But time remains of the essence. If the Facility is to be established in time to meet the projected needs of the MFIs, the decision as to whether or not to proceed with its creation will need to be taken in January 2000.

SCHEDULE OF ACRONYMS USED:

AMC	Ahli Microfinancing Company.
CBJ	Central Bank of Jordan
CD	Certificate of Deposit
CHF	Cooperative Housing Bank
DEF	Development and Employment Fund
FACILITY	The Alternative Funding Facility
GDP	Gross Domestic Product
GUVS	General Union of Voluntary Services
IDB	Industrial Development Bank
JHFHD	Jordanian Hashemite Fund for Human Development
JIC	Jordanian Investment Corporation
JLGC	Jordanian Loan Guarantee Corporation
JMCC	Jordanian Micro Credit company
JMRC	Jordanian Mortgage Refinance Corporation
JNB	Jordan National Bank
JWDS	Jordanian Women's Development Society
MIP	Microfinance Implementation Program
MFI	Microfinance Institutions
MTI	Ministry of Trade and Industry
NHF	Noor al Hussein Foundation
RFP	Request for Proposal
SC	Save the Children Federation
SOW	Scope of Work
UNWRAP	United Nations Works & Relief Agency for Palestinian Refugees

SECTION 1. INTRODUCTION AND SCOPE OF WORK:

1.1). In accordance with the contract signed with Chemonics International, dated September 20, 1999; the Consultant spent 41 calendar days in the Hashemite Kingdom of Jordan during the period November 6-December 16, 1999 working on the assignment. The Scope of Work (SOW) for this contract was categorized into three phases as follows:

PHASE I:

- Prepare an Options Study outlining various options and structures for the establishment of a Wholesale Funding Facility (the Facility), through which funds will be made available to Microfinance Institutions (MFIs) for them to finance their ongoing activities.
- Review the strengths and weaknesses of the Jordanian Loan Guarantee Corporation (JLGC)- both in terms of managing the proposed facility and/or acting as a guarantor of loans made to the MFIs by the Facility.

PHASE II:

- Prepare a detailed Business Plan for the facility, including product design, five-year financial projections, operating systems, credit criteria and monitoring systems.

PHASE III:

- Review JLGCs policies and procedures, and draft additional ones to enable them to implement their role as Manager of the Facility, should they be so selected.

1.2). This report consists of an executive summary, together with a detailed report for all of the above phases, and a five- year projection. It also includes sections on potential market demand for the facility, credit approval procedures and treasury management requirements.

SECTION 2. SOCIO-ECONOMIC OVERVIEW OF JORDAN:

2.1). The Hashemite Kingdom of Jordan is classified as a middle-income developing country. After five years of growth, during which the Gross Domestic Product (GDP) grew at an average annual rate of 5.5% per annum, the economy slipped into a recession in 1996. Since then, the economy has expanded only slowly, with growth rates of 1% in 1996, 1.3% in 1997, and 2.2% in 1998. The current per capita income is estimated at US\$1,520. For the next five years, however, real growth is expected to accelerate to 3.6% per annum. But while this growth will slightly outpace the historical population growth rate of 3.3% per annum, it translates into only a slight growth in per capita income over this period.

2.2). The public sector dominates the Jordanian economy, with nearly 60% of the work force employed in the public sector and/or the military, and with general government consumption amounting to 27% of the GDP. Furthermore, the public sector consumption grew at a rate of 5% per annum during 1998, thereby outpacing the overall economic growth in the country. Large-scale public consumption and capital investment spending have contributed to a fairly steady increase in the ratio of total debt to GDP, which peaked at 118% in 1997 before improving slightly to 116% in 1998. Over the medium term, this high ratio of public sector spending and investment to total GDP is expected to continue.

2.3). Despite the recent recession, the foreign exchange reserves have remained fairly steady at the US\$1.8-2.0 billion level for the last two years, and the exchange rate has been steady at 0.7 JD to the US\$. This stability, together with the recent fiscal policies, has led to a flattening out of the official inflation rate, which was estimated to be 3.0% in 1997 and 4.5% in 1998.

2.4). The World Bank's research indicates that between 1992 and 1997 considerable progress was made in poverty reduction within the Kingdom. During this period, measured poverty declined from 14.9% to 11.7% of the total population. However, while the poverty gap index has narrowed from 3.8% to 2.5% in 1997, the current recession will have increased poverty, particularly amongst those levels of society who do not have access to government employment. This situation is further exacerbated by the current unemployment rate of 15%.

2.5). While there are some indications that the economy is beginning to improve, the projected recovery will be gradual. But it will remain hostage to continued economic expansion in Europe and North America, and progress in the Middle East peace negotiations. Positive developments in these areas will encourage continued foreign assistance, increased tourism, and the opening of regional markets to Jordanian goods. Should these developments not be positive, the recovery could prove to be fragile.

2.6). With this economic background, and the current demographics of large numbers of school leavers entering the workforce, the possibilities for and the need for microfinance in Jordan are positive. While most new entrants into the labor force initially will look for employment in the public sector, there will be a large proportion of them who will be looking to create, or expand, small family enterprises to help support themselves. These businesses will represent the potential target market for microfinance practitioners in Jordan.

SECTION 3. BACKGROUND AND STATUS OF MICROFINANCE IN JORDAN:

Background:

3.1). The first microlending program in Jordan was founded in 1965 by the Industrial Development Bank of Jordan (IDB). Under this program loans were extended to small businesspeople at subsidized rates, primarily for small-scale industries and handicrafts. Following on the establishment of this program, other small scale lending activities were developed, including a loan program to students by the General Union of Voluntary Services (GUVES) in 1986 and the Development and Employment Fund (DEF) in 1992. The DEF program was conceived to be part of a poverty alleviation program, whereby income generation employment opportunities would be created. Since this time other programs have been established, some of which focus exclusively on microfinance/ microlending, and others which include it as part of a range of charitable and social services.

Current Status:

3.2). Currently, there are twelve institutions in Jordan providing financial services to microentrepreneurs. A current estimate of their total loan portfolio is:

Loan Portfolio Outstanding	18,900,000 JD
Current number of Active Loans	15,700

3.3). In broad terms, these institutions fall into two categories: microfinance institutions (MFI) providers, and social service institutions who provide loan services to the poor (Other Lenders). The main difference between the two groups are that the MFIs are part of the Sustainable Microfinance Initiative (SMI), undertake microfinance as their core activity, and are committed to being operationally sustainable over the medium to long term. On the other hand, the Other Lenders provide loans as part of a social welfare or employment generation mission, often at subsidized rates. Moreover, they have no commitment to operational sustainability over the medium to long term.

3.4). A brief overview of the major institutions in these two categories is included below:

The MFIs:

3.5). The MFIs are those institutions who are included in AMIR Microfinance Initiative Program (MIP) project, and are focused on creating a sustainable microfinance sector in Jordan. The participants are:

The Ahli Microfinancing Company (AMC), a subsidiary of Jordan National Bank (JNB).
The Cooperative Housing Fund (CHF), a subsidiary of the Housing Bank.

The Jordanian Micro Credit Company (JMCC); an affiliate of the Noor al Hussein Foundation (NHF)

The Jordanian Women's Development Society (JWDS), an associate member of the Save the Children (SC) global network.

3.6). A brief review of the scope, strategy and methodology of each of the institutions follows:

3.7). *JWDS*: JWDS was incorporated in December 1996 as a local NGO to assume responsibility for the microfinance program that had been started in the refugee camps by SC. JWDS has an exclusive female gender focus. Under its new business plan, it will be providing both group loan and individual loan products, within a range of 150 JD-2, 500 JD. Clients start with the smaller group based loan product, and graduate to the larger individual loans. The maturity of its loans range from 2 months (for a seasonal loan) to 15 months (for a capital investment loan). JWDS will be concentrating on the urban and peri-urban areas in the greater Amman and northern regions of the country. Its loans are for business purposes only. The effective annual interest rates for its loans range from 37% to 52%. As of September 30, 1999 its loan portfolio outstanding was 428,000 JD in 4,967 active loans. Its operational sustainability rate was 61%, and the portfolio at risk ratio was 3.6%. JWDS projects that it will achieve an operational sustainability ratio of 103% by 12/31/2001 and at that date its loan portfolio will be approximately 1,715,000 JD with about 6,800 active borrowers.

3.8). *AMC*: AMC is a 50% owned subsidiary of JNB, which is registered as a private shareholding company. Its business plan calls for the company to focus on providing individual loans to microentrepreneurs of both genders, with the aim of having 50% of its portfolio consisting of female borrowers. AMC will have three loan products, with the average loan sizes for each ranging from 2,000 JD to 7,000 JD and loan maturities ranging from 6 months to 18 months. The effective annual interest rate on these products will vary from 37% for the smaller loan product, to 14.6% for the largest loan size product. Their target market will be entrepreneurs with an estimated minimum monthly income level of 500 JD. The company will focus its efforts on the greater Amman and northern regions of the country. As part of its product line, AMC will offer savings account services at JNB to its clients. By year five AMC projects that its loan portfolio outstanding will be approximately 8,416,000 JD, representing approximately 5,800 active loans. Operational sustainability is forecast by the end of the second year. At this time AMC has just commenced disbursing loans.

3.9). *JMCC*: JMCC is registered as a non-profit private shareholding company under the Ministry of Trade and Industry (MTI). It has been established as the microfinance service provider of the NHF, and made its first loan in August 1999. JMCC uses the individual loan methodology. At this stage there is only one loan product, and the loan amounts are structured to increase by loan cycle from 200 JD to 650 JD. All loan cycles have a maturity of 20 weeks and have an annual effective interest rate of 42%. JMCC is gender neutral, but expects to extend 50% of its loan portfolio to women. The target market will be the greater Amman area and the northern regions. Loans will be made for business purposes only. The business plan calls for a loan portfolio outstanding of 1,521,000 JD at the end of year 5, consisting of 6,600 active loans. Operational sustainability will be achieved in year 4.

3.10). *CHF*: CHF is registered as a Non-Profit Company with the MTI, and has been operational since December 1998. It is an affiliate of the Cooperative Housing Foundation of Washington DC. Since its establishment it has entered in banking partnership with the Cairo Amman Bank, the Jordan National Bank, and the Bank of Jordan. These banks extend loans in an amount of 20% of the loan portfolio being financed, at commercial rates, thereby assisting CHF to fund its loan portfolio. CHF is receiving financial assistance from USAID as well, which eventually will amount to 2.8 million JD for funding the loan portfolio and 2.1 million JD to cover operational expenses. Their target market is in the southern governates of Jordan. CHF offers two loan products. The Group Loan Product focuses on women microentrepreneurs with an initial loan of 150 JD. This loan amount increases thereafter in incremental steps of 50 JD per loan cycle, to a maximum of 500 JD. The individual loan product extends loans of up to 14,000 JD with a maximum maturity of three years. Currently, it has 2,500 active borrowers and a loan portfolio outstanding of 1,400,000 JD.

Other Lenders:

3.11). Included in this definition are institutions whose major emphasis is on social development but who make loans to microenterprises as well. These lending institutions do not have as a specific goal that their loan portfolios achieve financial sustainability, and several of them are providing credit at subsidized rates. Full details of these institutions are included in Appendix 5. The more important of these lenders, and potential users of the Facility, are detailed below:

3.12). *Development and Employment Fund*: DEF is the largest of the Other Lenders, with a loan portfolio outstanding of 10.2 million JD, and 3,800 active borrowers. It makes loans of 1,000 JD-10,000 JD with maturities of up to seven years. It uses the individual loan methodology, and requires collateral for its loans. Its geographic focus is nationwide. DEF's interest rates, at 9% per annum calculated on a declining balance, are considered to be subsidized.

3.13). *The Jordanian Hashemite Fund for Human Development*: JHFHD is the second largest lender to microbusinesses from this group, with approximately 1,000 loans and a portfolio outstanding of 1.8 million JD. The loan sizes range from 150 JD to 6,000 JD and the loan maturities can extend for up to six years. The effective annual interest rate for loans with a maturity of one year is 21.5%. Loans are extended on an individual basis. It lends nationwide, but its main focus is in the greater Amman and the northern regions.

3.14). *The Industrial Development Bank (IDB)*: IDB is the third largest lender in terms of loan portfolio, with about 800 loans totaling 3.3 million JD. IDB is more of a general lender, however, making loans to both individuals and companies. Loan sizes range from 1,000 JD-10,000 JD, with a maturity of between 2 years to 7 years. The interest rate of 9% per annum, calculated on a declining balance basis, appears to be subsidized.

3.15). The other five lenders, the Near East Foundation, GUVES, UNWRAP, CARE, and the Noor Al Hussein Foundation each individually have less than 1,000 active loans and a loan portfolio of less than 1,000,000 JD.

3.16). The total loan portfolio of all eight Other Lenders totals 16,980,000 JD and approximately 8,000 borrowers.

3.17). While the total loan portfolio of these Other Lenders is relatively small, their impact on microfinance regarding the operational sustainability of individual microfinance lenders is disproportionate to their size. Firstly, the Other Lenders drain away financially attractive clients from the MFIs. Secondly, their subsidized interest rates, while not sustainable over the long term, force the MFIs to compete on disadvantageous terms. Thirdly, many of these Other Lenders are viewed as charitable foundations, and in the eyes of the borrowers their loans are really grants that don't have to be repaid. This perception has a ripple effect on the MFIs, who can experience difficulty in obtaining repayment as a result of this perception.

3.18). The continuation of some of these practices, particularly the use of subsidized lending rates, however, may be short-lived. It is understood that the Government has been asked to review its policy of providing financial assistance to institutions providing loans at subsidized interest rates.

SECTION 4. PROJECTED DEMAND FOR MICROFINANCE FOR THE PERIOD 2000-2004

4.1). During the last eighteen months there have been three market surveys undertaken to measure the demand for microfinance in Jordan. These surveys are:

(i). The CDG survey, The Demand for Microfinancial Services in the Micro and Small Scaled Enterprise Sector in Jordan. July 1998.

(ii). The WIDTECH survey: Research Findings on Women's Participation in Microenterprise, Agriculture, and the Formal Financial Sector. February 1999.

(iii). The CDG survey, Market Specifics Survey #1, East Amman. Ongoing.

4.2). All of these surveys are somewhat incomplete regarding the quantification of the demand for microfinance in the Kingdom.

4.3). The initial survey by CDG ((i) above) projected total demand for microfinance loans in excess 328 million JDs¹.

4.4). The second survey by CDG ((iii) above) estimated the number of microbusinesses in East Amman at about 30,000, of which 75% would be interested in utilizing debt capital. With East Amman comprising 20% of the total population of Jordan, this would extrapolate out to about 115,000 microbusinesses nationwide, who could be potential clients of microfinance lenders.

4.5). The WIDTECH survey ((ii) above) estimates the total target market for female-headed microbusinesses to be approximately 63,000 entities². The initial CDG survey opines that women entrepreneurs comprise approximately 30%-35% of the total microentrepreneurial population³. Combining these statistics, the total number of microbusinesses in the Kingdom would extrapolate out to 190,000 entities.

4.6). While a clearer picture of the total demand for microfinance loans in Jordan will have to await the finalization of the second CDG survey, the potential demand is probably in the range of about 150,000 businesses. Moreover, with the high unemployment level expected to continue for the short to medium term, this number is likely to increase.

¹ Page 56 of their report.

² Page 84 of their report.

³ Table A5 and Table A6 of the CDG Report dated July, 1998.

4.7). The estimate of 150,000 borrowers needs to be discounted, however, by a factor to allow for those businesses who do not want to borrow, do not need to borrow, or are not considered creditworthy. A widely recognized discount rate for microfinance is 40%. Applying this discount rate to the potential pool would reduce the likely target market to 90,000 eligible microfinance businesses.

4.8). A pool of 90,000 potential borrowers is large enough to support several microfinance lenders in Jordan at an operationally sustainable (and probably financially sustainable) level over the medium to long term. But, it is not large enough to support twelve lenders. Consequently, there will need to be a consolidation amongst the participants, with the number of lenders reducing to a maximum of, say, 6-7. All of these remaining lenders will need to have a clearly thought out strategic plan, a detailed marketing strategy, and a sound credit analysis and approval system. They will also need to have “critical mass” of at least 5,000 -7,000 active loans at all times. As a consequence of these conclusions, the proposed Facility will have a client base of 6-7 potential borrowers, not all of whom may be creditworthy at any given time. The Facility Manager, therefore, will need to have either a strong credit analysis capability, or very strict loan approval criteria so as to differentiate between those potential borrowers who represent good credit risks and those who do not.

SECTION 5. PROJECTED DEMAND FOR FINANCING BY THE BORROWERS FROM THE FACILITY.

5.1). As discussed in Section 4, “Projected Demand for Microfinance in Jordan”, it is anticipated that there will be a maximum of 5 eligible borrowers from the Facility at any one time. They will consist of the four identified MFIs plus one of the likely two who probably will be eligible for access.

5.2). It is somewhat difficult to estimate exactly what the funding requirements from the Facility will be for a five- year period, due to:

(i). Most of the MFIs current business plans are stale, and are in the process of being updated.

(ii). The uncertain status of AMC’s capital structure. The original plan was that the JNB’s capital investment of 750,000 JD into AMC would be matched by foreign investors, thereby giving AMC a paid-up capital base of 1,500,000 JD. Furthermore, these outside investors also would provide 50% of the debt capital requirements of AMC, which will total 5,100,000 JD by the end of year 5. Unfortunately, however, the CBJ has indicated that it will withhold approval for any foreign investors to either invest in or lend to AMC. Furthermore, JNB is not permitted extend loans to AMC for the time being. Therefore if AMC is to meet the goals of its original business plan, it may need funding from the Facility of up to 6,800,000 JD.

5.3). An accurate estimate of the potential demand from the Facility, therefore, will have to await the presentation of current business plans from JMCC, CHF and AMC. Additionally, clarification is needed from AMC as to how it proposes to resolve its capital structure issues.

5.4). As an interim step, however, a preliminary demand projection has been prepared, based on current available data, which is detailed below;

(In 000’s JD)

Borrower	Yr 1 Q3	Yr 1 Q4	Yr 2, 1H	Yr 2, 2H	Yr 3	Yr 4	Yr 5
JWDS		150	265	640	940	1,040	990
AMC	687	687	3,106	3,106	5,991	6,843	5,853
JMCC		100	180	420	620	690	660
CHF		700	700	700	1,000	1,500	1,500
Other				640	940	1,040	990

Total	687	1,637	4,251	5,506	9,491	11,113	9,993
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5.5). The above projections are based on the current business plan of JWDS, the maximum funding gap that AMC currently faces, an estimate for JMCC based on the fact that its loan portfolio size will equal 66% of JWDS, and that the Other Lender will approximate JWDS in funding requirements. CHF indicated that it will need 700,000 JD in the fourth quarter of calendar year 2000, and will rise slowly thereafter.

5.6). The above projections represent a worst case scenario under which AMC is not able to source any further debtor equity capital from other sources while the loan portfolio growth matches the business plan. It would therefore look to the Facility for all of its incremental funding needs. This sets the potential maximum funding need at approximately 11,000,000 JDs, peaking in year 4.

5.7). The minimum funding need can be approximated by assuming that AMC can source its capital requirements from elsewhere, and that no "Other Lender" qualifies for loans from the Facility. The minimum amount of the Facility would therefore be about 3,300,000 JD, which also crests in year 4.

5.8). The extremely rough projections indicate that the funding for the Facility can be made available over time. These funding allocations could approximate 1,700,000 JD required by the end of calendar year 2000; 5,500,000 JD by the end of calendar year 2001; 9,500,000 JD by calendar year 2002; and 11,000,000 JD by the end of calendar year 2003. These capital requirements would be reduced however, by the accretion of the capital of the Facility caused by the reinvestment of retained earnings from ongoing operations. See Phase II, Business Plan.

SECTION 6. POTENTIAL SOURCES OF FUNDING FOR THE FACILITY:

6.0). As discussed in Section 5 “Projected Demand by MFIs from the Facility”, the potential demand for funds from the Facility could range up to 11,000,00 JD (US\$ 15.5M). However, the amount to be sourced as capital for the Facility will be less, because of the impact retained earnings will have on the capital structure of the Facility.

6.1). In the SOW provided for this assignment, paragraph 2 “Background”, states that “under the AMIR program, USAID is considering making the necessary funds available for setting up this facility. A large enough pool of funds should be made available to meet the financing needs of the microfinance institutions’ over the next three years, provided a satisfactory structure for the management of this facility can be put in place”. This understanding that the start-up and medium term funding would be supplied by USAID was reinforced during a meeting held with USAID staff on November 18, when the possible size of the Facility of 4,000,000 –10,000,000 JD was discussed. While the meeting did discuss the possibility of involving other Funders/ investors, such as IPC or IFC, the discussion focused on approaching other institutions after the facility was established, and had developed a performance track record. This will occur after several years of operations. In the meantime, though, if the Facility is to be established, all of the funding would be sourced from USAID. Furthermore this funding would be in the form of a grant.

6.2). The circumstances have now evolved whereby USAID may not provide all of the initial financing, and/or the availability of the funding could be delayed. If this is the case, alternative funding will have to be obtained quickly, since several MFIs will need additional capital in the second half of calendar year 2000. Should it develop that there is no immediate funding forthcoming from USAID, AMIR should consider a twin track approach for raising funding for the Facility. (a) Focus its efforts on getting a small amount of funding quickly so as to meet the immediate needs (say 1,000,000 JD). Then (b) use this breathing space to source larger sums of capital from other sources and/or give USAID sufficient time to obtain approval for aid requests.

6.3). For these alternative sources of funds, three possible options have been identified:

(i) *Other External Donors*: There is general agreement that microfinance has a key role to play in helping the Jordanian economy achieve real growth and aiding in poverty alleviation over the medium term. Furthermore, initial reactions are that a structure like the Facility provides a vital link for the creation of sustainable MFIs. It is recommended that upon the acceptance of the report, and after the potential demand for the Facility is better quantified, which confirms the sustainability of the concept, other potential donors be approached regarding their interest in participation. Possible providers of start-up capital include the Dutch Government, the European Union, the British Department for International Development, and possibly SC. These organizations are likely sources of

“soft” or grant capital, making them ideal partners for the start-up capital. While they should be able to inject capital into the Facility more rapidly than investor capital, whether they can respond in time for the creation of the Facility is unknown at this stage.

(ii). *Other External Investors:* A variation of searching for other donor funds would be to approach external investors who, rather than granting funds to the Facility, would invest in it as a business proposition. Their capital injection could take the form of:

Debt Capital: They could be approached for a medium to long term loan with a maturity of a least five years, but callable on six months notice. The maturity of five years would enable the Facility to plan its activities over the medium term knowing that it has a secure source of funding, but at the same time it could call in the debt on reasonably short notice. Depending on the attitudes and risk profile of the lenders, these loans could be structured as either senior or subordinated debt. From the viewpoint of the Facility, subordinated debt would be preferable, since it would allow greater flexibility in managing their capital structure. The interest rate, however, would be higher than what would be payable on senior debt.

Equity Capital: Equity capital would involve the investor in a risk sharing partnership with the other founders of the Facility. This investment could be in the form of either ordinary shares, or preference shares with a call date set at, say, five years after the date of issue. Investing through the purchase of ordinary shares means the investment would be long term and profits would accrue through the payment of dividends and the increase in the net asset value of the shares. External investors may prefer to purchase Preference Shares with a set maturity at par, but would pay a higher fixed dividend provided there are sufficient profits to cover the dividend payments. This is a lower risk alternative to purchasing ordinary shares, since they would be cashed out on a set date and would take precedence over ordinary shareholders for the payment of dividends.

Potential providers of either debt or equity capital should be knowledgeable of the risks of investing in developing countries, and understand the microfinance market. Some institutions that have invested in microfinance programs internationally, and might be possible candidates include the International Finance Corporation, the German IPC, RABO Bank of the Netherlands, or some of the U.S. based socially conscious mutual firms such as Calvert Funds, the Parnassus Fund, and Devcap. Internally within Jordan it is possible that DEF may be interested in being an equity funder of the Facility. This possibility should be pursued.

The equity alternative, however, will be more time consuming than approaching donor-agencies, since extremely detailed business plans will have to be submitted to them, plus there will be extensive legally guided business negotiations about the capital structure and legal profile of the Facility. The tax implications will need to be explored in detail as well. These factors will conspire to render this a slow alternative to raising finance for the Facility. This option is more appropriate when the Facility is established, has created a credit history of good performance, and when time is not of the issue.

(iii). *AMIR Contract/Grant Modification*: Under this approach, AMIR would request approval from USAID to modify the original terms of the existing grant, whereby funds could be re-allocated to finance the start-up of the Facility. This approach has the attraction of being the easiest of all of the options to accomplish, and should be the quickest to implement. A variation of this approach would be for USAID to establish a separate grant from existing resources to fund the Facility.

6.4). The key issue of timing, however, remains. USAID needs to provide a clear direction as to how the Facility is to be financed, and this direction should be obtained by January 31, 2000 at the latest. To leave a decision regarding how the Facility is to be financed beyond this time will severely weaken its ability to raise alternative financing by the time it will be needed in the second half of calendar year 2000.

SECTION 7. POSSIBLE STRUCTURES FOR THE FACILITY:

7.1). On the basis that there would be a demand for the Facility, possible structures were explored. These structures were considered from both a legal viewpoint, and from a management effectiveness approach.

7.2). The following alternatives for structuring the Facility are available for consideration:

(i). The Facility would be legally incorporated as a legal entity, either as a Perpetual Trust, a Perpetual Fund or a Limited Liability Company. As such, it could be designed as either a stand-alone institution with its own staff, or it could be managed on a sub-contractual basis by an existing organization. This existing organization could be in either the public or the private sector.

(ii). The Facility to be designed as a grant, to be disbursed on a one time basis.

(iii). Divide the available pool of funds into a group of smaller funds and make these funds available to identified beneficiaries for a trial period. The beneficiaries would administer these smaller individual funds themselves on a trust basis, using fund accounting practices. These separate funds would be audited by an external firm of accountants. Then, after a successful stewardship of five years, these individual funds are dissolved and the proceeds gifted to the beneficiaries.

7.3). These options are discussed in detail below:

Option (i): A Stand Alone Legal Entity.

7.4). Under this structure, a separate Trust, Fund or a Limited Liability Company would be registered under the appropriate Jordanian Law. The benefits of using a stand alone legal structure are:

- It is self-funding. The operational expenses of running the facility are paid from interest and investment income, and any surplus profits are re-invested.
- As a separate legal entity, it will be managed by a Manager/ Administrator, whose sole responsibility is the wellbeing of the Facility. He will report to the Board of Directors, or Trustee, who will oversee the Facility manager's performance on a regular basis.

- The publication of financial accounts on a stand-alone basis will greatly add to the transparency of the operations.

7.5). The differences between the three possible legal options are as follows:

7.6). As a stand-alone entity, there are three legal entities that could be used; the registration as a fund, a limited liability company, or as a trust.

7.7). *Registration as a Fund:* The Facility would be registered under the Securities Act of 1998. The shareholders in the fund would have to be nominated by AMIR. The duties and responsibilities of the Manager would be defined by the Fund Agreement with the shareholders of the Fund, and under the Fund's Certificate of Incorporation. Being registered under Jordanian Law, international links or expertise should not be required to operate the Facility effectively, so both local and international organizations should be eligible for consideration.

7.8). *Registration as a Trust:* Currently, Jordan does not have a Trustee Act as the term is understood in US-British Commonwealth Law. Thus the Trust would have to be registered offshore, possibly in Cyprus or in Bahrain. The duties and responsibilities of the Trustee would be outlined in the Trustee Act of the host country, and in the Trust Agreement itself. In terms of operational effectiveness it should not raise operational difficulties for managers with international operations, such as the local offices of international banks, but it may create difficulties for local managers without offshore operations. Moreover, the issue of who assumes the foreign exchange risk will need to be resolved.

7.9). *The Limited Liability Company:* This structure would be registered with the Registrar of Companies under the Ministry of Trade and Industry. It would consist of a Board of Directors, who would also be the shareholders in the Company. The company would have a Memorandum and Articles of Association of the company and these, together with the regulations of the Companies Act, would establish the duties and responsibilities of the Officers and the Board of Directors.

7.10). The specific roles and responsibilities of the Managers or Trustees would be contained within the articles of incorporation of the Trust or the Fund, or by way of a management contract between the Manager and the legal entity of the Facility.

7.11). The Stand Alone Facility option could be established in two ways. (A) It could be administered either by an existing organization, who would administer it on a sub-contractual basis behalf of the beneficiaries. Or (B) it can be managed by a full time staff specially recruited for the Facility. The strengths and weaknesses of these two alternatives are as follows:

Alternative A: A Perpetual Facility Administered by an Existing Entity on a Sub-Contractual Basis:

7.12). The administration of a Facility by an existing organization has substantial advantages, of which the main ones are: -

- The existing institution would have the basic physical infrastructure in place, namely offices, communications etc.
- The institution would have the appropriate MIS and investment management software systems currently in operation, thereby avoiding potential problems in designing and starting up these systems from scratch.
- There would be the skilled staff in house who could handle both the investment and credit duties inherent with the duties of a manager or trustee.

7.13). These attributes will enable the facility to achieve a faster start-up than otherwise would be the case.

- The institution would have a “track record” of a good performance of undertaking these responsibilities. This will provide an indicator of their future professional competence.
- The administrator would be taking a “reputation risk” whereby should they perform poorly, their established reputation in the marketplace as a reputable institution would be sullied.
- An established administrator would have built in economies of scale in their operations. This would translate into a lower cost of operations for the Facility than otherwise would be the case.

7.14). The main disadvantages would be of this approach would be:

- The facility may be too small to warrant the attention of the senior staff of the Manager or Trustee, with the result that it is poorly administered by junior, or less-experienced, staff.
- Unless the administrator assumes some of the risk for credit and/or investment losses, there is no incentive for them to manage the facility in a prudent fashion. Conversely, potential administrators may not wish to assume any credit or investment responsibility.

7.15). There are two broad alternatives to selecting an existing entity, namely from the public sector, or from the private sector. Potential candidates from the private sector would be the major accounting firms, the commercial and investment banks, and the Jordanian Funds and Investment Trusts. The institutions in the public or quasi-public sector would could be considered are those such as the IDB, JLGC, the Jordanian Investment Corporation (JIC) and the Jordanian Mortgage Refinance Company (JMRC). There are no clear advantages of selecting an institution from the private sector in preference to the quasi-public sector, save two:

(i). The perception that the quasi-government institution is in fact managing government funds. This could lead to the undesired result that the terms and conditions of the loan would not be taken seriously by the borrower.

(ii). The private sector institution would have more of a commercial approach to the operation. This would result in a quicker decision making process, and a more hard headed approach to making loans and enforcing lender's legal rights.

7.16). The final decision, though, should be made on the basis of who presents themselves as the most effective and efficient manager at a reasonable cost.

Options for Structuring the Responsibilities of Management under Alternative A:

7.17). There are two possible options regarding the responsibility of the Manager, depending on which approach the appointed Manager and AMIR agree to utilize. These approaches are either an administrative model, or an accountable management model.

7.18). *The Administrative Model:* With this model the Manager acts as an administrator, who will follow a strict set of performance criteria, and does not exercise any discretion in the conduct of their duties. AMIR will lay down strict requirements for: loan applications, credit approval criteria, loan product structure, collateral/guarantee standards, the setting of the maturity and pricing of the loans, and will define the circumstances under which loans to delinquent borrowers will be foreclosed. AMIR will also define the investment instruments in which any surplus cash will be invested. The performance of the Administrator will be measured by how closely these guidelines are adhered to.

7.19). The Administrator will not be responsible for any losses incurred by the Facility, as long as the requirements as laid down are strictly followed.

7.20). The management fee will be established as a set rate, with no performance bonus. Naturally, this fee will be less than what would be paid under the accountable management model.

7.21). *The Accountable Management Model:* With this approach, the Manager will have full discretion over the management of the Facility. This will include exercising his own judgement over the approval of loan applications, the types of loan made, the collateral/guarantees required, and when a delinquent borrower will be foreclosed on. They will also have full discretion over the investment of short-term surplus funds.

7.22). Under this model, the Manager will be expected to stand behind his credit and investment decisions, and will, therefore, accept a proportional sharing of any losses incurred. Should the Manager wish to limit the amount of such losses, he can purchase a loan guarantee policy from institutions such as the Jordanian Loan Guarantee Corporation (JLGC), the premium of which would be for the Manager's expense.

7.23). The fee payable under this model will be set on a two- tier basis. The first tier will be a basic administrative fee, which is designed to reimburse the Manager for administering the Facility. The second tier will be a performance-based fee, or bonus. The criteria for this performance fee/bonus will be set by a combination of revenue earned, the number and amount of loans made, and loan portfolio quality criteria (defined in accordance with the regulations of the Central Bank of Jordan). The bonus/fee can take the form of a profit sharing arrangement, whereby the net income of the Facility is divided with the Manager, or it could be a progressively increasing bonus payment linked to the performance of the Facility.

Alternative B: A Perpetual Facility as a Stand-Alone Institution.

7.24). Under this model the Facility would be financed as a start-up organization, establishing itself in both a legal and physical sense as a separate operating entity. In addition to legally registering itself, and establishing its own governance structure, it would be necessary to:

- Establish its own physical facilities.
- Establish a MIS and software programs
- Recruit staff.

7.25). The combination of the above tasks will lead to a slower start-up and a possibly higher cost base than otherwise would be the case⁴.

⁴ For Example, the salary for a manager would per 36,000 JD p.a; the salary for an analyst would be 18,000 JD p.a. the annual rent for an office would be 8,000 JD, office and secretarial support would be 36,000 JD p.a., and capital expenditure could be 10,000-15,000 JD.

7.26). Other disadvantages of this approach would be:

- Difficulty in attracting quality staff to manage the Facility. The demands of the assignment would be less than what could be found in other parts of the financial sector, and the Facility could be limited regarding the salary level it could afford to pay.
- As a smaller institution, its overheads would be higher than if it were part of the larger financial organization. For example, external audit costs, access to financial market data, and legal support costs would be considerable for a smaller organization. Regretfully, size does count in the financial sector.

7.27). On the other hand, there are considerable advantages to establishing a stand-alone, self-managed facility. These include:

- Greater focus on the purpose of the facility, since this is the *raison d'être* of the organization. As part of a larger organization with other goals, close attention may not be paid to developments in the microfinance sector of Jordan.
- Faster turnaround time to loan requests and repayments problems would result from a small organization devoted exclusively to managing the facility.
- Highly specialized expertise would be garnered by a core of staff devoted exclusively to microfinance.
- The staff in general, and the Facility Manager in particular, could be held more directly accountable for their performance.
- Financial reporting would be more transparent. With this approach the MIS system could be designed from the ground up, rather than being derived from an existing MIS system.
- This structure would provide a better check and balance mechanism on the operations of the borrowers than would a sub-unit of a larger organization.

7.28). Of these two options Alternatives A, that the Facility be administered by an existing entity is the preferred choice. It will permit a fast start-up for the operations; require little, if any capital expenditure; will be more cost-effective; and will reduce the risk of the Facility suffering from inexperienced management.

Option (ii): Structure the Facility as a Grant.

7.29). With this option, the funds that otherwise would be part of the Facility would be granted to an existing institution to disburse them to the MFIs in accordance with a Grant Agreement. As such there would be no separate fund or facility to finance microfinance lenders in the Kingdom on an ongoing basis. The advantages of this approach would be:

- Since the grantee would assume ownership of the funds, the bureaucratic follow-up procedures by AMIR would be minimal.

7.30). The disadvantages of this structure are:

- The funding available under this facility for microfinance activities would not grow over time, since the net earnings from the funding would not be reinvested in the Facility for on-lending on a rotational basis.
- The financial performance of the fund would be difficult to measure, since they are not accounted for separately by the administrator.
- Transparency in financial reporting would be difficult to achieve.
- Commitment to the purpose of the funding would wane over time, since other objectives of the administrator and the recipients would assume priority in the decision making process.
- A core of knowledge would not be achieved, since the administrator would not be pressed to focus on microfinance, since the funds have been gifted to the recipients.
- It would be difficult to implement independent oversight by way of a Board of Directors or a Trustee.

7.31). This approach is considered to be incompatible with the aim of ensuring that the funds will be used for financing microfinance activities over the medium term and on a sustainable basis. This is due to the lack of transparency, the lack of accountability, and the likely waning of commitment over time to the purpose of the grant.

Option (iii): Identify the Potential Beneficiaries and have them Manage Their Own Funds as Trustees on a Fund Accounting Basis. Then, After a Successful Stewardship of Five Years, These Individual Funds are Dissolved and the Proceeds Gifted to the Beneficiaries as Equity.

7.32). Under this approach, the funds from the Facility would be lent to pre-designated lenders for a period of five years. During this period the MFIs would have to maintain the proceeds as a

separate fund and prepare financial statements on a fund accounting basis. During this period regular reports would be provided to a Board of Directors who would be appointed for this task. The Board would be advised by a professional firm of Accountants, or Bankers about the performance, control procedures, and adherence to the guidelines of the Facility by the recipients. Performance would be measured against a previously submitted business plan, and other previously established performance criteria. If, after five years, the MFI's performance is found to have been satisfactory, the ownership of the Facility Funds would be transferred to the lenders by its conversion into equity.

7.33). The advantages of this structure are as follows:

- The borrowers would assume full responsibility and accountability for the performance of the funds entrusted to them.
- Reporting would be transparent through the use of the fund accounting mechanism.
- The net earnings from these loans would be reinvested back into the individual Fund, thus building them up over time.
- The segregation of the Facility's assets from the borrower's other assets ensure that they will be used only for the prescribed purposes.
- Should the borrower's performance be unsatisfactory, the money in the individual funds can be recalled upon demand.
- There is a built-in incentive for the beneficiaries to live up to their obligations, since if their performance is judged to be successful, the funds will be converted into equity after five years.
- It encourages managerial self- reliance on behalf of the beneficiaries.
- This is something of a low cost, hands-off option, since the Board of Directors would probably use the good offices of one of its members for its support services, and the monitoring and reporting to the board could be subcontracted to an accounting firm.

7.34). There are, however, several disadvantages to this option:

- All of the potential beneficiaries would have to be identified and evaluated in advance. Thus, should other worthy beneficiaries surface over time, there would be no funding available for them.

- In the circumstances where the beneficiary's performance is unsatisfactory, and the funds are withdrawn, the beneficiary may experience problems in achieving a 100% loan repayment rate from their end borrowers, particularly when word spreads that no repeat loans will be forthcoming. Moreover, such a step could create long term damage to the reputation of microfinance in Jordan.
- Each beneficiary would have to install a Fund Accounting MIS/ accounting system. This system does not integrate easily with a standard MIS accounting system, and is difficult to record and administer.

Conclusion:

7.35). Of the above mentioned four options, it is recommended that Alternative A, a perpetual facility administered by an existing entity on a sub-contracting basis is the most appropriate structure. This approach offers the fastest start-up, the lowest capital expenditures, effective administration, transparent accountability, and the best approach to attracting skilled professionals who can manage the Facility in the most cost-effective manner.

7.36). Regarding the most appropriate legal vehicle to be used, the legal advice indicates that the easiest, cheapest and most transparent approach is to register the Facility as a Limited Liability Company under the Companies Act.

7.37). The registration of the Facility as a Fund under the Securities Act is not practical since this would permit the Facility to invest in stocks and bonds only, and not make loans to MFIs.

7.38). The establishment of an Offshore Trust, while having distinct attractions, has three disadvantages that make it less desirable than a Limited Liability Company. These are:

- (i). It limits the choice of potential managers to those who have offshore operations
- (ii). As with all of the alternatives, Central Bank clearance would be needed. Legal counsel, however, feels that CBJ could be reluctant to approve an approach that allows the MFIs to borrow offshore.
- (iii). The issue of who bears the foreign exchange risk would need to be resolved.
- (iv). There could be conflicts between Jordanian Law and the laws of the host country that might be difficult to resolve.

SECTION 8. THE ROLES AND RESPONSIBILITIES OF THE MANAGER OF THE PROPOSED FACILITY:

8.1). Regardless of the form or structure adopted for the establishment of the Facility, and whether the administrative or accountable model of management is used, the general duties and responsibilities that the Manager will encompass the following:

- Administer the Facility in accordance with the underlying goals for which it is to be established.
- Comply with the legal and regulatory requirements of the Kingdom of Jordan.
- Assume responsibility for safeguarding the assets of the Facility in accordance with the management contract.
- Manage the assets, liabilities, capital and transactions on a stand-alone basis, so that they are not commingled with other activities of the Manager.
- Manage the affairs of the Facility in a prudent manner.
- Under the accountable management model, assume the legal responsibility for any losses incurred in either the loan portfolio or the investment portfolio.
- Report on a regular basis to the Board of Directors/Trustees/AMIR.
- Oversee the production of an audited annual report that complies with the reporting requirements of the Kingdom.

8.2). These general requirements, together with the more specific duties and responsibilities, will need to be defined in the governing document of the Facility. Whether this document is the Memorandum and Articles of Association, a Trust Agreement, or a Management Contract will have to be decided. Additionally, they would need to be included in the Funding Agreement with USAID or other donors, if such a document is required.

8.3). The Manager of the Facility initially will be hired for a trial period, and a term of one year is recommended. If the performance during this period is satisfactory, the contract then would be renewed for a further period of, say, two years. Thereafter, the position of the Manager, regardless of the legal structure used, would be subject to an open tender for a following three-year period.

8.4). The specific duties and responsibilities under the two options will be as follows:

Specific Duties and Responsibilities Under the Administrative Model:

8.5). The specific duties and responsibilities of the Manager under this model are categorized as: Governance, Accounting & Reporting, Loan Approval and Loan Portfolio Management, Cash Flow Management, Investment Management and Administrative Duties. Details of the categories of duties and responsibilities are as follows:

Governance:

8.6). These duties will include:

- (a) Assist AMIR in the establishment of the Legal Vehicle.
- (b) Establish safekeeping facilities for the necessary legal documentation for the Facility. This will include the physical custody of the certificates of incorporation and the loan documentation.
- (c.) Comply with the necessary legal and regulatory reporting requirements, including the lodging of any government mandated returns.
- (d). Ensure that any tax payments are made expeditiously.
- (e). Establish an effective system of Internal Controls, which meets the requirements of the external auditor. The external auditor will be appointed by AMIR.
- (f). Prepare and lodge the annual audited financial statements for shareholders and other interested parties.
- (g). Prepare an annual business plan for the Facility, with guidance from AMIR.
- (h). Provide sufficient office support facilities to enable the staff assigned to manage the Facility to conduct their duties in a responsible manner.
- (i). Provide the facilities for the formal meeting of the Board of Directors and the General Assembly.
- (j). Prepare all of the necessary reports and presentations for the meetings of the Board of Directors and the General Assembly.

- (k). Provide secretarial services for these formal meetings and prepare the minutes of these meetings.
- (l). Supervise compliance with any other legal requirements.

8.7). Accounting and Reporting Requirements:

- (a). Establish/adjust the accounting system so as to be able to record and report on the assets, liabilities, capital and transactions of the Facility on a fund accounting basis.
- (b). Design/Modify the Management Information System (MIS) so that it can perform the following tasks:
 - (i). Loan Portfolio tracking
 - (ii). Investment Portfolio management
 - (iii). Cash Flow Management (including projections)
 - (iv). Prepare the reports required by legal and regulatory requirements.
 - (v). Provide the required reports to AMIR.

The formats of the above-mentioned reports will be provided by AMIR.

- (c.). Establish/adjust the accounting and internal control procedures for the management and control of all transactions, the flow of information and the creation of an audit trail for the Facility. This duty would be best accomplished by working in conjunction with the designated external auditor of the Facility.
- (d). Enter all transactions in the accounting systems and maintain the integrity of the underlying database.
- (e). Produce monthly reports on the loan performance⁵
- (f). Produce monthly reports on the investment portfolio performance
- (g). Produce monthly financial statements.
- (h). Prepare monthly bank reconciliations.

8.8). Loan Approval and Loan Portfolio Management:

⁵ AMIR will prepare all forms for use by the Manager.

- (a). Review annual business plans provided by the MFIs for the establishment/renewal of the annual credit facility.⁶
- (b). Review audited annual financial report of the MFIs, as part of the review for the establishment/renewal of the annual credit facility.
- (c.). Approve the loan facility, as long as the MFI meets the defined guidelines as outlined in the Section 13 “Credit Criteria for Potential Borrowers”. Thereafter, notify the MFI of the approval. Details of the credit analysis, and other working papers, are to be maintained in separate credit files for each MFI.
- (d). Prepare legal documentation for the establishment of the Facility. These will be standard forms, which will have been prepared in advance.
- (e). Sign legal documentation on behalf of the Facility.
- (f). Review and approve the loan drawdown requests by the MFI under its respective credit line. In particular, the schedule presented by the MFI of projected loan repayments from microbusinesses that it will use to finance the repayment to the Facility is to be scrutinized carefully.
- (g). Disburse the loan drawdown to the MFI.
- (h). Monitor the loan performance repayment monthly, through the loan tracking system.
- (i). Collect and deposit the monthly loan repayments of principal and interest from MFIs. This system can be structured on a self-management basis, whereby the MFIs would deposit funds directly into the Facility’s bank account.
- (j). Undertake loan recovery procedures, including enforcing legal claims when loan repayments by the MFIs are past due. The loan recovery procedures will be outlined for the Manager by AMIR.

8.9). Cash Flow Management:

- (a). Prepare annual cash flow projections for the Facility on a monthly basis, using the projection model to be provided by AMIR.

⁶ See Section 12 “Proposed Loan Products”.

- (b). Manage the liquidity of the Facility, so that there is sufficient funding available to meet both the borrowing requirements of the MFIs, as well as the payment of operational expenses.
- (c.). Invest and redeem surplus funds in approved short-term investment instruments, so as to minimize surplus non-income earning funds. See Section 17, “Treasury Functions”.
- (d). During the start-up phase of the Facility, request drawdowns of funds from USAID/AMIR on an as needed basis.

8.10). Investment Management:

- (a). Establish an investment portfolio tracking system.
- (b). Invest surplus funds, as indicated by the cash flow projection model, in an approved list of short- term investment instruments. AMIR will set the definition of surplus funds.

8.11). Administrative Duties:

- (a). Open and administer the necessary bank accounts and custody accounts in the name of the Facility.
- (b). Establish safe depository facilities for the loan documentation, and other legal records for the Facility. This will include the design of a legal documentation register.
- (c.). Identify or hire staff for the management of the Facility.
- (d). Make the designated staff available for training in microfinance, which will be provided by AMIR.
- (e). Prepare an annual business plan for the Facility, for approval by the Board of Directors and/ or by AMIR.
- (f). Pay all operational expenses of the Facility.
- (g). Review and prepare a summary report for AMIR on the monthly operational reports forwarded to the Facility by the borrowing MFIs.
- (h). Prepare the monthly reports on the performance of the Facility to AMIR, and the Board of Directors.
- (i). Manage the annual audit of the Facility by the external auditors.

Specific Duties and Responsibilities Under the Accountable Management Model:

8.12). Under this model the duties and responsibilities fundamentally will be the same as under the Administrative, but with three exceptions:

- (i). There will be less oversight of the Manager by AMIR and the Board of Directors, thereby reducing the intensity of the reporting requirements.
- (ii). AMIR will not provide specific guidelines for the loan approval and investment policies of the Manager.
- (iii). The external auditor will conduct a management audit as well as an legal audit of the operations of the Facility.

8.13). The following specific duties and responsibilities under the administrative model will be adjusted for this model as follows:

- The reports outlined under the Accounting and Reporting Requirements are to be prepared quarterly instead of monthly.
- Loan Approval and Loan Portfolio Management, bullet point (c.). Instead of following the guidelines for approving the loan, the manager will be able to exercise their own discretion concerning approving or rejecting the credit facility application and approving or rejecting the loan draw-down request by the MFI.
- Investment Management, bullet point (b). The Manager will be able to invest the surplus (as defined by AMIR) at their own discretion.

8.14). The offset to this reduction in the level of oversight, and the increase in the use of their own judgement, is that the Manager will be held accountable for any losses that occur. This applies if the losses result from the exercise of poor judgement, inadequate internal controls, or a downturn in the local economy. On the other hand, the Manager will be eligible for a performance-based bonus.

SECTION 9, REVIEW OF THE JORDANIAN LOAN GUARANTEE CORPORATION AS A POSSIBLE ADMINISTRATOR OF THE FACILITY:

9.1). The SOW requires that the consultant evaluate the strengths and weaknesses of the Jordanian Loan Guarantee Corporation (JLGC) regarding its candidacy as a potential institution to manage the Facility. Furthermore, recommendations should be made regarding any needed organizational and operational changes that would be necessary for JLGC to implement, so that it could manage the Facility. As an alternative, this review should also explore the possibility of JLGC providing guarantees for loans made by the Facility, if the Facility were to be managed by another party. Finally, under phase 3 of the SOW, JLGC's policies and procedures are to be reviewed, and new ones drafted, to enable JLGC to undertake its duties, should it be appointed as manager of the Facility.

9.2). In undertaking this component of the SOW, the consultant met with the senior management of JLGC⁷, reviewed the report of an audit undertaken by an audit team from USAID, examined JLGC's annual report for Financial Year 1998, and held discussions with senior officials with USAID. Additionally, opinions about JLGC's reputation amongst the financial community were canvassed during the meetings held with representatives from the formal financial sector of the Kingdom⁸.

9.3). In the course of this the review, the following findings were ascertained:

- The audit report undertaken by an audit team from USAID Cairo⁹ raised several concerns regarding JWDS' operations. These included:
 - (i). JLGC appeared to have gone beyond the terms of the written agreement regarding the granting of guarantees to businesses larger than permitted, and increased the program limits. While the USAID mission may have known about these variances, nothing had been documented by either party concerning a waiver of the original terms of agreement.
 - (ii). The fee structure charged for the guarantee programs were insufficient to cover the operational and loan loss expenses. While JLGC was aware of this problem, and knew that the fee structure for the export credit guarantee had not been subject to an actuarial study, no steps had been taken to correct them. JLGC indicated to the audit team that it

⁷ Meeting with Dr. Saleh and Mr. W. A. Zir on October 4, 1999.

⁸ It is understood that a leading accounting firm also has undertaken a review of JWDS. The consultant, however, has not been made privy to this report.

⁹ Audit of Jordan Loan Guarantee Corporation's Implementation of USAID/Jordan's Loan Guarantee Activities; July 15, 1998.

would request assistance from USAID to correct these shortcomings. Another example of a slow reaction to potential problems noted by the Audit Team was that no study had been undertaken to ascertain whether or not there was an underlying pattern to the guarantee defaults that had occurred.

(iii). The audit report noted that the provision for the payment of a dividend to the CBJ was contrary to the Program Implementation Letter. Additionally, the audit report stated that this provision needed to be reversed, so that these funds could be reinvested into the capital of JLGC. The USAID Mission's letter of response to the audit report noted this finding, and stated that they had requested that the provision be reversed and the funds be credited to the reserves. Furthermore, USAID had requested that the CBJ not withdraw any funds in the future. But note 9 of JLGC's audited financial statements as of 12/31/1998 states that these dividends have been deferred until August 30, 2002. This completely contradicts USAID's wishes in this regard.

- In addition to the matter of the deferment, rather than the cancellation of the dividend payment to the CBJ, several other issues arose from JLGC's 1998 annual report.

(i). The value of JLGC's investments were written down by 20% during the year. This calls into question either JLGC's investment analysis capabilities.

(ii). JLGC appears to be an expense heavy institution. For example, during 1998 the number of JLGC staff fell from 28 to 27, while salaries and wages rose 35% during the year. These figures suggest that JLGC would not be a cost-effective manager of the Facility, an important consideration in light of the goal that the Facility be financially sustainable from the commencement of its operations.

- Subsequent to our meeting with him, Dr. Salah, the then Director General, has been appointed to a new position as Secretary General of the Ministry of Planning, and a new Director General, Mr. Said Himani has been appointed. This management turnover, while not having a long term impact on JLGC's ability or otherwise to manage the Facility, does suggest that the senior management should be given time to settle into its new position before they are burdened with any new responsibilities.
- The CBJ has expressed certain reservations about the MFIs having a direct relationship with JLGC "at this time".

9.4). These above issues suggest that JLGC may not be the ideal institution to manage the Facility, at least in the short to medium term while these above issues remain outstanding. Furthermore, to ask JLGC to manage the Facility, while simultaneously providing loan guarantees, a service that is perceived to be an extremely useful contribution, would represent a major conflict of interest for management. Therefore, it is recommended that JLGC not be requested to act as the manager of the Facility. Consequently, JLGC's policies and procedures have not been reviewed as is outlined in the SOW. However, it is proposed that negotiations be opened with JLGC regarding them

providing loan guarantees for the loans made by the Facility to the MFIs, or by the MFIs to their clients, to obtain an expression of interest for this proposal. Then, the manager can apply to JLGC for such insurance coverage, should it be deemed necessary.

SECTION 10. POTENTIAL EXTERNAL MANAGERS OF THE FACILITY:

10.1). An integral part of the SOW was to identify and design a management structure for the Facility. One of the principal conclusions of the consultancy is that the most efficient cost-effective approach for the management issue is to sub-contract the management to an existing financial sector institution.

10.2). To this end, the following firms were contacted, initially to enquire as to whether they would be interested in managing such a Facility, should it be established. These firms were selected from a broad spectrum of the financial sector. The Professional Accounting Firms were also queried as to their level of interest in undertaking the management audit and legal auditing roles, which are outlined elsewhere in this report.

Jordan Investment Trust PLC
Arthur Andersen
Citibank
PriceWaterhouseCoopers
Jordan Mortgage Refinance Co. Ltd.
Deloitte Touche Tohmatsu
Industrial Development Bank
HSBC
Jordan Investment Corporation

10.3). At this stage the following responses have been received.

Jordan Investment Trust:	Interested in managing the Facility on the Administrative Model only.
Arthur Andersen:	Not interested in a managerial role, but is keen to undertake the management audit and legal audit functions.
PriceWaterhouseCoopers:	Interested in managing the Facility on the Administrative model basis. They are also interested in performing the management audit and legal audit functions.
Jordan Mortgage Refinance	They are interested in managing the Facility. They

Corp. proposed that initially they would start with the Administrative model, and then performance permitting, might progress to the Accountable Management model.

Industrial Development Bank. Primarily they are interested in the Administrative model, but did not rule out the Accountable Management model.

10.4). These responses indicate two points. Firstly, there is considerable interest in managing the Facility on a sub-contractual basis. Secondly, the majority of the potential managers are risk averse, preferring the Administrative model of management contract.

10.5). Based on these responses, the next step should be to prepare a detailed outline of the job description and send it to the applicants requesting proposals from them and including their fee structure for undertaking this responsibility. This job description could be based on the following sections of this report:

Section 8. Roles and Responsibilities of the Manager of the Proposed Facility

Section 11. Outline of the Terms and Conditions to be Included in the RFP and the Management Contract with the Facility Manager.

10.6). When these proposals are received they will need to be reviewed in light of the applicants' ability to manage the Facility, their experience in undertaking these types of duties and responsibilities, and their professional and ethical standing within the business community.

SECTION 11. AN OUTLINE OF THE TERMS AND CONDITIONS TO BE INCLUDED IN THE RFP FOR THE SELECTION OF THE FACILITY MANAGER:

11.1). Detailed below are the key criteria that are to be included in the Request for Proposal (RFP) and /or in the management contract (the Contract) for the position of Manager:

- *Legal Status of the Manager:* The manager must be a registered legal entity within Jordan, who is permitted to hold property, and make investments in financial instruments both within and external to Jordan. If the facility is established as an offshore Trust, the Manager must be registered to make investments in both the host country of the Trust, as well as in Jordan (RFP).
- *Years of Establishment:* The Manager must have been in operation for at least three full financial years (RFP).
- *Minimum Capital Requirement:* The prospective manager is to have a minimum net worth of 10,000,000 JD both prior to and during the life of the contract (RFP and Contract). If this is not possible due to the corporate structure of the Manager, an acceptable bond can be posted.
- *Fiduciary Responsibilities:* As part of its Memorandum and Articles of Association/ Certificate of Incorporation, as well as under the Law of its incorporation, the Manager must have the specific authority to undertake Fiduciary activities. Moreover, the Manager must have a minimum of three years experience at undertaking fiduciary duties and responsibilities (RFP and Contract).
- *Experience in Credit Analysis:* The Manager must provide have at least two years experience in analyzing financial institutions from the viewpoint of extending loans or making equity investments, or of auditing/advising institutions undertaking these activities. This experience could be displayed by supplying and list of the previous mentioned transactions, or by making available for review details of their procedures for undertaking such financial analysis (RFP).
- *Loan Administration:* The Manager is to provide details of their existing or proposed Loan Administration and Tracking Procedures. This system must be able to administer and track at least 25 loans simultaneously (RFP).
- *Protecting the Assets of the Facility:* The manager is required to have both the capacity and the willingness to pursue legal remedies in those cases where the loans made to MFI lapse into

default, or in other circumstances where the assets of the Facility are put at risk (RFP and Contract).

- *MIS Systems:* The MIS system of the Manager is to have the capacity to produce Financial Statements required by AMIR on a fund accounting basis. Additionally, the Manager is to have the proven capacity to produce the loan portfolio and reports as outlined in the Section 16, Loan Monitoring Systems/ Recommended Reporting Systems. (RFP and Contract)
- *Experience in Managing a Portfolio of Short Term Investments:* The Manager is required to have at least three years of experience in managing a portfolio of short- term investments, either within or outside of Jordan, or auditing/ advising firms who do. (RFP).
- *Investment Portfolio Tracking System:* The Manager is to have an effective investment portfolio tracking system. This system is to be capable of tracking the short term investment portfolio of the Facility so as minimize the amount of idle cash on hand in the Facility's current account at any one time. Furthermore, the system must be able to produce the reports on the Short Term Investment Portfolio as detailed in the Section 16. (RFP).
- *Annual External Audit:* The Manager is to be subject to an annual external audit, to be undertaken by an audit firm, approved by AMIR. Currently these firms are

Arthur Andersen (Allied Accountants)
 Deloitte and Touche (Saba & Co)
 PriceWaterhouseCoopers (Bawab & Co)
 Whinney, Murray, Ernst &Ernst
 KPMG Peat Marwick

At the time of lodging the proposal, the prospective managers are to provide financial statements for the three preceding years, which have been audited by one of the above-mentioned firms (RFP and Contract).

- *Duties and Responsibilities:* Depending on which management model is adopted (The Administrative model, or the Accountable Management model), these will need to be established in detail and can be based on Sections 8 and 11. (RFP (outline), Contract (detailed)).
- *Fee Structure:* This will depend on which of the two the management models is to be adopted, and will be the subject of negotiation between AMIR and the Manager/ Administrator. As part of the formal RFP, applicants are to be requested to submit a schedule

of fees for consideration. The annual fee should be paid quarterly in arrears. (RFP (proposal from applicant), Contract (detailed)).

- *Length of the Contract:* Initially, the contract will be for a one-year tenor, which upon satisfactory performance will be extended for a further two years. After the expiry of this three year period, the new contract should be put out to open tender (RFP and Contract).
- *Circumstances Under Which the Contract will be Cancelled:* The circumstances under which the Facility/AMIR has the right to cancel the administrative/management contract need to be described in detail (the Contract).
- *Governing Legal Code and Settlement of Disputes:* If the Facility is located in Jordan, the Jordanian legal code will be the governing legal statutes. If an Offshore Trust is used, either English or New York State Law should be the governing statutes.

SECTION 12. PROPOSED LOAN PRODUCTS FOR THE FACILITY:

Background:

12.1). General banking practice in Jordan is to provide only short-term credit facilities to clients, primarily through the use of an overdraft facility, with medium to long term credit representing only a small proportion of the total. It should be noted that, theoretically, an overdraft can be called in by the lending bank on a demand basis. Apparently, it is very unusual for Jordanian commercial banks to lend for longer than a five-year maturity, and such loans would apply only to top grade major corporations. For high quality middle market clients, the maximum maturity available to them would be three years¹⁰.

12.2). While there may be unsatisfied demand for long term credit in the Kingdom in general, and in microfinance in particular, these types of loans are not being made. This is partially because the managerial capability to analyze and approve them, and the necessary MIS systems to monitor them, are lacking, as is the availability of creditworthy long-term borrowers.

Requirements of Users of the Facilities:

12.3). A review of the funding needs for the most likely borrowers under the facility¹¹ display an overwhelming focus on providing short-term loans to their clients. This estimated loan demand is as follows:

AMC: 70% of loan portfolio < 6 months maturity = 1,211,000 JD Yr. 1
= 5,891,000 JD Yr. 5

JWDS 85% of loan portfolio < 10 months maturity = 1,337,000 JD Yr. 2
82% of loan portfolio < 10 months maturity = 1,946,000 JD Yr. 5

JMCC 100% of loan portfolio < 5 months maturity = 251,000 JD Yr. 2

¹⁰ Meeting with Mr. F. Sharaf. Manager, Investment Banking Unit, Export and Finance Bank, November 10, 1999.

¹¹ JWDS, AMC, JMCC, CHF

= 1,521,068 JD Yr.5

CHF 11% of loan portfolio < 6 months maturity = 29,000 JD Yr. 1

84% of loan portfolio < 6 months maturity = 3,400,000 JD Yr. 5

12.4). These projections indicate that the overwhelming need for financing by borrowers will be for short- term funds. While some lenders, such as AMC and JMCC will be making loans with maturities of up to 18 months (for AMC), the proportion of the loans compared to the total portfolio will be relatively small.

12.5). With this background, it is proposed that the Facility's loan products for the MFIs be short term in nature, with the maximum maturity set at thirteen months. The reasons for this are threefold:

- (i). It will match the cash cycle of the end clients as well as matching the cash cycle of the borrowers from the facility.
- (ii). Shorter loan tenors, correctly structured, will involve less risk for the Facility.
- (iii). It complies with the historical experience of both lenders and borrowers in Jordan, and therefore will not entail a change in the mindset of both borrowers and lenders.

Proposed Loan Products:

12.6). Within this maximum tenor of thirteen months, two loan products will be offered, each of a different maturity:

- (i). *Short Term Loan:* The first product will be for up to six months. This product is tailored for use by those borrowers who offer loan products to their clients with short maturities. This will include the Ramadan Loan Product for JWDS, together with the initial group loan products offered to its borrowers. Also, it will be appropriate for JMCC whose proposed loan products have a maximum maturity of 20 weeks.
- (ii). *Long Term Loan:* The second loan product will be for a maturity of between 6 months and 13 months, and is intended for usage for working capital loans and capital investment loans with a repayment period of less than 13 months. This loan product is targeted at AMC "B" product with its tenor of 12 month, and JWDS's individual working capital loan of 10 months and tranche 1 of the capital investment loans that have a maturity of 12 months. This structure will also permit financing to be available for loans of a shorter maturity under CHF's Individual Loan Product.

12.7). Repayments to the Facility will be made on a monthly basis for all loan products.

12.8). Consideration was given to the idea of creating a revolving line of credit or an overdraft facility for the potential borrowers. The proposal of an overdraft was ruled out on the basis that it needs to be tied to a bank account, and therefore can only be issued by a registered commercial bank. The proposal of a revolving line of credit for general use was also decided against at this stage. International practice has shown that MFIs generally do not have strong treasury management skills, and that the tendency is for them to re-invest all surplus funds in their loan portfolio rather than setting aside the proceeds of loan repayments to repay their own facility. As a result, when the lender demands repayment from the MFI, the MFI has to call in its loan portfolio, which then triggers widespread defaults. Given this situation, the Facility will lend against a clearly defined loan portfolio only, the proceeds of which will be specifically earmarked for the principal repayment.

12.9). The maturities of these loan products will need to be reviewed at least annually to match the developing needs of the MFIs. The underlying principal should remain, though, that the facility provides the short term financing requirements of the MFIs, while they use their own resources to fund the longer term needs of their client base.

12.10). The collateral requirements will vary by the assessed level of risk, and the projected usage of the line of credit. The key asset that the MFIs have is their loan portfolio, and where possible this should be accessible by the Facility if need be. The loan documentation between the Facility and the MFI will need to be structured so that the Facility is in a priority position to other creditor parties in the collection of these loans. Furthermore, the Facility needs to have the option to collect the outstanding loan portfolio in its own name, should the MFI be declared bankrupt.

Operational Procedures for the Facility:

12.11). The proposed operational procedures for using the Facility will be as follows:

- (i). After the MFIs have prepared their annual business plans, and if these plans project a need for loan capital, they should submit a request for a 'line of credit'.
- (ii). The Manager will review the application for the line of credit.
- (iii). If the request for a line of credit is approved. The MFI is notified as such, and legal documentation for the line of credit is completed. The maturity of the Line of Credit will be for one year, renewable annually subject to an annual review.

- (iv). When the debt capital is needed, the MFI requests the borrower, and simultaneously presents a schedule of the loans that will be funded and/or the cash flow of loan repayments that will repay the loans (this latter option is included is the loan is requested to pay operating expenses). The principal repayment terms are then structured so as to match the loan repayments being received by the MFI. The advantage of the line of credit loan draw down structure is that the Manager will not have to review each drawdown request in detail, since the bulk of the analytical work will have been done at the time the line of credit is approved. This will result in a faster disbursement than otherwise would be the case.
- (v). The loan is then repaid monthly, both principal and interest.
- (vi). All initial borrowings from the facility will be the short-term working capital loan. Then, after the MFI has successfully serviced this initial loan, it can access the long-term loan product.
- (vii). After the MFIs have demonstrated their ability to manage their treasury functions effectively, greater flexibility could be introduced by not tying the loan repayments by the MFIs to the Facility with the loan repayments the MFIs receive from their borrowers.
- (viii). When MFIs have proven their capacity under (vii) above, greater flexibility could be introduced by making available a revolving facility to the MFIs.

12.12). While these requirements might be stricter than creditworthy clients could avail themselves of in the commercial market, this is more than offset by the pricing structure. See Section 14, “Proposed Pricing Mechanism for the Loan Products to be Offered”.

SECTION 13. CREDIT QUALITY CRITERIA FOR POTENTIAL BORROWERS:

13.1). In order to ensure the ongoing viability of the Facility, only those borrowers who present a viable business plan will be considered for loans. Furthermore, these borrowing institutions must meet additional criteria such as compliance with the mission statement of the AMIR program, proper legal status, and the managerial ability to implement their operational plans. The purposes of these criteria are twofold. Firstly, to ensure that the borrower is financially sound, and will be using the loan proceeds for the purposes for which it is intended. Secondly, these criteria will act as a screening mechanism, so that when loan applications are received, it is likely that the loan request will be approved. These criteria are proposed as initial guidelines, and will need to be modified as experience is gained regarding their applicability.

13.2). These criteria will be both quantitative and qualitative in nature, and fall under the following categories:

Governance:

Financial Viability:

Target Market:

Loan Structure:

Reporting Requirements:

Governance:

13.3). The borrowers will have to meet the following terms and conditions re corporate governance:

- Registered as a Non Profit Company, or a Limited Liability Company with the Register of Companies, under the oversight of the Ministry of Trade and Industry.
- The borrower, or its antecedents, must have at least fifteen months of operational experience in the field of microfinance at the time of the loan application.
- At least 50% of the Board of Directors are not to be employed by the borrower, the parent of the borrower, or an affiliate of the borrower. At least two Board Members will have a background, or formal education, in banking, finance, or accounting.
- The Memorandum and Articles of Association specify that the primary purpose of the borrower is to provide financial services to microentrepreneurs on an operationally sustainable basis.

- The Board of Directors is required by the Articles of Association to meet at least once a calendar quarter.
- Provide audited financial statements, including a Balance Sheet, an Income Statement, and a Cash Flow Statement (Sources and Uses of Funds) annually. These financial statements are to be prepared in accordance with the International Accounting Standards Committee's guidelines. The audit is to be undertaken by one of the auditing firms listed in the Section 18 "Compliance and Audit Criteria", in accordance with International Auditing Standards.
- Loans to board members are prohibited. Loans to staff are allowed, but subject to the same terms and conditions as other borrowers, and the loan amounts are pegged at 75% of the loan sizes permitted to normal clients.
- Senior management, including the Program Director, the Finance Manager and the Operations Manager, must collectively have three years of experience with microfinance. Moreover, the Program Director must have been with the MFI at least six months before a loan drawdown can be made.

Financial Viability:

13.4). At the time of application the borrower must be able to meet the following financial criteria:

- Present a realistic business plan that projects the achievement of operational sustainability within 4 years of commencing operations, and the achievement of financial sustainability within six years¹². In the case where MFIs are already well established, the targets should be 3 years and 5 years respectively.
- Have achieved an operational sustainability ratio¹³ of at least 50% for the preceding six months.
- The trend of the operational sustainability ratio must be positive, improving at an annualized rate of at least 20%.
- The portfolio at risk ratio, measuring late payments as those which are past due longer than 30 days, of less than 7.5%.
- The loans in arrears ratio, measuring arrears as those loans with repayments due that are past due more than 30 days, of less than 2.5% of the total loan portfolio outstanding.

¹² As defined by CGAP/SEEP

¹³ As defined by CGAP/SEEP.

- The Loan Loss Reserve must equal at 2.5% of the total of the loan portfolio outstanding.
- Total equity to have averaged in excess of 600,000 JD for the preceding six months. Additionally, the trend for the growth of total equity must be positive, increasing at an annualized rate of 10% per year.
- The equity multiplier ratio before borrowing under the facility is to be less than 1.5:1.0. Including the loan request, the equity multiplier is to be less than 2.5:1.0.
- The debt to equity ratio before borrowing under the facility is less than 0.5:1.0. Including the loan request, the equity multiplier is to be no more than 1.5:1.0.
- Liquidity. The borrower is to have sufficient liquidity (defined as cash, short term investments and loan principal repayments receivable within the next thirty days) equal to the total of 8.33% of the total annual operational budget plus 4% of the projected annual loan disbursements.

Target Market:

13.5). The borrower's mission statement must include as a primary goal, the provision of banking services to microentrepreneurs. Microentrepreneurs are defined as individuals who conduct a business activity with fewer than ten employees. There is no requirement regarding gender other than contributing towards AMIR's goal that 50% of the combined loan portfolio of all of the MFIs are loans to women. There is no a minimum requirement or target for agricultural or rural loans.

13.6). In order to meet this requirement, only 10% of the number of individual loans disbursed during the preceding twelve months are to be for amounts greater than 7,000 JD (inflation adjusted). Additionally, these loans must not exceed 25% of the loan portfolio outstanding during the same twelve-month period.

Guidelines for the Loans extended by the MFIs that are Eligible for funding from the Facility:

13.7). For the Manager to approve a line of credit for the MFI, the MFI's own loan criteria must comply with the following:

- The loans must be for business purposes.
- The maximum maturity for loans to be funded by the line of credit will be 12 months.

- A lump sum repayment of principal at the maturity of the loan must not exceed 40% of the principal amount borrowed.
- Interest payments on the loans must be made at least monthly.
- The maximum loan sizes to be financed under the line of credit are 5,000 JD

13.8). If the loan is to be for covering operational expenses, the outstanding loans whose repayments will be used to repay the loan from the Facility must comply with the above guidelines.

Reporting Requirements:

13.9). *Reports to be Produced by the MFI for the Facility:* To ensure that the MFI is capable of generating enough management information for its own internal management purposes, and to meet the needs of the Facility manager, the following reports must be produced in a timely manner.

Monthly/ quarterly Income Statements
Monthly/ quarterly Balance Sheets
Monthly/quarterly Cash Flow Statements
Monthly Liquidity Projections
Monthly Loan Portfolio Reports by:
 Aging
 Credit Agent
 Branch Office
 Loan Type
 Loan Purpose
 Loans Past due, by credit agent
 Portfolio at risk, by credit agent
Summaries of actual results against forecast
Annual five year budgets/forecasts, with semi-annual revisions.
Ratio analysis, using the SEEP/CGAP ratios.

13.10). *Reports to be prepared for the Facility:* The reports to be forwarded to the Facility are outlined in the Section 16 “Loan Monitoring Systems/ Recommended Reporting Systems”.

SECTION 14, PROPOSED PRICING MECHANISM FOR THE LOAN PRODUCTS TO BE OFFERED:

Issues to be Considered in Establishing the Lending Rate:

14.1). The identification of a pricing mechanism to use as a basis to establishing the interest rates on the loan products took into account the following issues.

(i). Access: In common with international experience, the main challenge microfinance lenders face is obtaining access to debt capital, rather than the price of such capital once it is obtained. The barriers to accessing debt capital from the commercial banking sector normally consist of: (i) Perceived un-profitability of lending to MFIs, due to the relatively small loan size. (ii) Lack of regulatory oversight. (iii) Inability to post real assets as collateral. (iv) Inexperienced management. (v) An insufficient track record. (vi) A lack of understanding about microfinance by the lender. Hence, once access was gained, microfinance lenders would be prepared to pay market rates, particularly since best practices outline the need to “cost” equity capital and subsidized lines of credit at an “imputed cost of capital”.

(ii). Sustainability of the Facility: It is essential for the facility to be financially sustainable if it is to make funding available to microfinance providers over the medium to long term. Consequently, its interest rates must be set at a level to cover operational costs, amortize the costs of capital equipment, allow for loan losses and increase the capital of the facility at a rate that at the least retains the purchasing power of the available funding over time. In sum, the facility must not be viewed as a cheap source of funds.

(iii). Transparency: The microfinance community needs to be reassured that the interest rate is not set in a capricious manner. Consequently, it needs to be linked to an index that is widely understood, and is published by a reputable authority on a regular basis. Moreover, this index needs to represent market conditions.

(iv). Affordability: It is axiomatic that access to the debt capital markets needs to be priced that represents a reasonable balance between lender and borrower so that it matches their individual risks and rewards. Concern has been expressed, however, that setting the cost of accessing the facility at a competitive borrowing rate would result in an interest rate that would be too high. A more appropriate “price” would be one that approximates the wholesale cost of funds to the commercial banking sector. This would be in the form of a weighted average cost of funds for the commercial banking sector.

(v). *Level of Utilization:* The Facility is to be structured as a “lender of recourse”. As such borrowers need to view the facility as a source of funds when their other, cheaper, sources (primarily equity) of capital have been exhausted. Furthermore, access to the facility should not be permanent, rather it should be accessed on a last source basis, and be the first source to be repaid. To encourage this attitude by borrowers, an incentive will have to be reflected in the pricing.

14.2). Complying with all of these issues is challenging, particularly the ones concerning sustainability and affordability.

14.3). Access: The issue of access will be an issue of creditworthiness. Access will be available to all institutions who meet the initial credit criteria, or who are judged to be good credit risks by the administrator/ manager. There will be no limitations on the minimum size of loans, and the loans products available will be priced according to structure, maturity, and amount. As noted in the Section 4 “Projected Demand for Microfinance in Jordan for the Period 2000-2004”, the number of institutions who would be expected to qualify for access to the facility is estimated to be 6 or 7 microfinance lenders.

14.4). Transparency: The issue of transparency regarding the setting of the interest rates will be addressed by using as an index one of the statistics published by the CBJ. The CBJ issues a monthly statistics publication providing data on the various interest rates operating within the economy. This survey is public knowledge, and is readily available within the financial community. The use of a rate published in the survey, or using a rate published in the survey as a benchmark for establishing the interest rate would make the procedure for setting interest rates clearly transparent.

14.5). Utilization: The level of utilization will be controlled by a combination of the loan structure and the loan pricing. The pricing of the loan will need to be set so that (i) a real interest rate is charged, and (ii) this interest rate is comparable to the borrower’s other sources of funds. To meet these criteria, the interest rate will need to be set at a margin above both the national inflation rate and the imputed cost of capital that would be charged on donated capital and subsidized loans.

14.6). Affordability and Sustainability: The need here is to strike a balance between: (i) the requirement that the facility covers its costs and to avoid the appearance of providing cheap money to the borrowers. (ii) To keep the cost of funds at a level that does not imperil the operational sustainability of the borrower.

14.7). Various mechanisms were considered in order to meet the above criteria:

The Commercial Banks' Weighted Average Cost of Capital:

14.8). To price the funds at an approximation of the weighted average cost of funds to the commercial banking sector appears unrealistic for several reasons:

- Individual banks do not make these costs public knowledge and therefore transparency becomes an issue.
- Due to the high level of liquidity in the commercial banking, the major commercial banks primarily fund themselves from current accounts and savings accounts. The interest rates on a majority of these accounts pay a negative real interest rate, thus setting the weighted average cost of funds at an artificially low level.
- It will be difficult to “cost” the capital of the commercial for a weighted average cost of capital calculation, since three of the five biggest banks do not pay a dividend¹⁴.

Pricing the Facility Using a Government Debt Instrument as a Benchmark:

14.9). There are several government debt instruments that could be used as a benchmark for pricing the facility. These are:

14.10). The Re-discount Rate: The re-discount rate is the rate at which the CBJ will lend to Commercial Banks against commercial bills of exchange, should the banks have the need for liquidity. This rate is set by the CBJ and is used to provide liquidity to the financial system as well as influencing interest rates. The relevance of this rate regarding the setting of interest rates is somewhat questionable at this time, given the high level of liquidity in the overall economy, and the ease with which commercial banks are attracting deposits.

14.11). Certificates of Deposits (CD) Issued by the Central Bank of Jordan: These CDs are issue by the CBJ as a means to “mop-up” liquidity rather than as a mechanism to finance the Treasury. As such they would be competitive with the interest rates offered by the commercial banking sector on their long-term time deposits. The result, however, has been that savers have not wanted to invest in these long- term instruments. The commercial banks, however, have continued to mobilize short- term savings and have invested these funds in the longer term CDs, thereby reaping the benefit of a risk free spread between the interest rates. By their design the usage of these instruments only will

¹⁴ Cairo Amman Bank, Jordan National Bank, and Union Bank.

continue to be operational as long as there is surplus liquidity in the economy. As such they are not a good long-term benchmark for setting interest rates.

14.12). Treasury Bills Issued by the Department of the Treasury: The Treasury market in Jordan for treasury bills/bonds appears to be relatively thin, with only 32 million JD issued in the first 6 months of 1999 and 3.9 million JD issued in all of 1998¹⁵. Moreover, the vast majority of these bills were issued for short-term maturities; thereby they are not really representative of the overall market. This factor, together with the shallowness of the overall market indicate that this could be an unreliable indicator.

14.13). The Weighted Average Overnight Interbank Loans: Currently, the published rate for this product is 4.40%-5.00%. This rate is considered unrepresentative of a classic interbank rate since the banks are all extremely liquid, and secondly, the stronger banks will not lend to the weaker banks.

14.14). Licensed Banks Credit Facilities: The CBJ's survey publishes a statistic for the local equivalent of a "prime rate" in the Kingdom. These rates are classified into three categories: the Overdraft Rate (the most frequently used facility), The Loans and Advances Rate, and the Discounted Bills and Bonds rate. This rate is an average of the rate used by the commercial banks to lend to their prime clients. It does not, however, include the fees and commissions that are customarily charged by the banks in addition to this underlying rate. As a result, this rate understates the actual cost of borrowing, possibly by up to 150 basic points.

Conclusions:

14.15). Of the above rates, the most appropriate for use as a benchmark for the Facility appear to be the Re-discount rate, or the licensed banks credit facilities rate. Either benchmark would have to be adjusted so as not to overprice it (possibly the licensed bank credit facilities rate), or under price it (the Re-Discount rate). Further the loan products should be priced to reflect the risk being taken by the Facility in extending the loan to the MFIs. To accomplish this, it is proposed that the structure be established in a grid pattern. Potential borrowers will be divided in "prime borrowers" and "normal borrowers". Additionally, the loan products themselves were be priced independently, with the short-term loan product priced lower than the long term loan product. Therefore "prime borrowers" taking out a short-term loan will pay a substantially lower interest rate than a "normal borrower" drawing down a long-term loan.

¹⁵ Dr. K. Elian. -Jordan Times, 11/25/99.

14.16). Initially, all borrowers will be classified as “normal” borrowers. “Normal borrowers” will be classified as “prime borrowers” when they meet certain performance criteria. These criteria should include the following:

- Have successfully serviced two previous loans from the Facility.
- The MFI’s on-time loan repayment rate on its portfolio for the preceding six months has been > 98.5%
- The MFI’s own portfolio at risk ratio for the preceding six months has been < 7.5%.
- The MFI’s actual financial performance for the previous six months has been within 5% of the projected gross income, net income, portfolio outstanding, and return on total assets ratio; and the trend of all of these results continues to be positive.
- The MFI has complied with all the Facility’s reporting requirements in an expeditious manner.

14.17). Should a borrower who has been classified a “prime” fail to meet any of these requirements during the tenor that a loan is outstanding, they will be downgraded to a “normal” status for the next loan.

Conclusion:

14.18). Based on the above issues, it is recommended that the Central Bank Re-Discount be used as the benchmark rate, and that the pricing for categories of borrower and the loan product be added to this base.

14.19). The proposed pricing is as follows:

	<i>Current Rate</i>
Prime Borrowers	
Short Term Loan, < 6 months =Rediscount Rate + 2%	10.5%
Long Term Loan, 6-13 months =Rediscount Rate + 4%	12.5%
Normal Borrowers	
Short Term Loan, < 6 months = Rediscount Rate +3%	11.5%
Long Term Loan, 6-13 months = Rediscount Rate +5%	13.5%

14.20). Once the loan is disbursed, the interest rate will remain fixed until the maturity of the loan, regardless of any movement in the underlying discount rate during this period.

14.21). Interest will be payable of a monthly basis, calculated on the average daily balance of the loan outstanding during the month, and will be calculated on a declining balance basis.

14.22). A late payment penalty of 5% per annum will be levied for each day the loan repayment is late. No grace period will be allowed.

SECTION 15. POTENTIAL INCENTIVES FOR GOOD CREDIT HISTORY

15.1). As noted earlier, the role of the Facility is twofold; firstly to make funding available to MFIs during the growth stage of the development cycle, and secondly to familiarize the borrowers with the operations of the commercial banking sector. This latter role includes encouraging good borrowing practices, so that the MFIs will be able to qualify for highly competitive interest rates. Consequently, incentives for good loan repayment have been built into the loan products. These are as follows:

(i). *Loan Pricing*: As noted in Section 14, “Proposed Pricing Mechanism”, all MFIs initially will be classified as “normal borrowers”. Then, after they have successfully completed two loan cycles, and meet the other criteria, they will be classified as “prime borrowers” and be eligible for the lower interest rates.

(ii). *Laddered Approach to Loan Products*: Initially, all MFIs can borrow only under the short-term facility. Then, if they successfully service this loan, they will be eligible for the long-term loan product.

(iii). *Loan Size*: Prudence dictates the initial loans extended by the Facility will be relatively small. But the policy will be to extend progressively larger loans as the MFI establishes a good credit history.

(iv). *Evolution of the Terms and Conditions of the Loan*: As the Facility is structured, for the first few loans each MFI will have to identify the sources of repayment for the loan at the time the loan disbursement is requested. After several successful borrowings, though, this requirement can be eased so that the source of repayment for the loan does not have to be identified in advance. For this to occur though, the MFI will have to be able to demonstrate that they have developed an effective treasury management system within their organization.

15.2). A further incentive, which has not been discussed in depth in this document since MFIs will not qualify for this for several years, is that the Facility could consider making available a revolving line of credit to qualified MFIs. This line of credit could be drawn down on demand, and repaid at will without any pre-determined repayment schedule.

15.3). These incentives, plus the non-bureaucratic approach to accessing credit, should make the Facility attractive to potential borrowers.

SECTION 16. LOAN MONITORING SYSTEMS/ RECOMMENDED REPORTING SYSTEMS:

16.1). There are two components to the reporting requirements of the Facility: reporting by the borrowing MFIs to the Facility and reporting by the Facility to AMIR.

Reporting by the Borrowing MFIs to the Facility:

16.2). These reporting requirements will include:

- The annual business plan
- Monthly/quarterly balance sheets (Appendix 4, Table 1)
- Monthly/quarterly income statements (Appendix 4, Table 2)
- Monthly/quarterly cash flow statement (Appendix 4, Table 3)
- Monthly/quarterly loan portfolio reports (Appendix 4, Table 4,5)
- Monthly/quarterly financial ratio reports (Appendix 4, Table 6)
- Monthly/quarterly cash flow projection (Appendix 4, Table 7)
- Annual audited financial statements (at the time of the initial request these statements for the preceding year will be required). The auditor of these financial statements will have been approved by AMIR.

16.3). These reports should mirror the internal reports that the MFIs are generating for their own internal use, and therefore should not require a major re-tooling of their MIS system. If it would be useful, the EXCEL programs could be provided to the MFIs for their use.

Reporting by the Facility to AMIR:

16.4). These reports also fall into two categories; the legal requirements and the internal management requirements.

16.5). The legally required reports will be set by the government or appropriate law statute, which will govern the operations of the Facility.

16.6). The management reporting requirements that will need to be prepared are as follows:

- A Monthly Fund Accounting Report
- A Monthly Statement of Revenue and Expenses
- A Monthly Loan Portfolio Report
- A Monthly Investment Portfolio Report

A Monthly Investment Portfolio Cash Flow Statement for both Principal and Interest.
Annual audited financial statements. The auditor of these financial statements is have been approved by AMIR.
Annual business plan and projections
Quarterly balance sheets
Quarterly income statements
Quarterly cash flow statements
Quarterly loan portfolio report by
 Aging
 Loan product
Quarterly summary of actual results against budget
Quarterly ratio analysis¹⁶.

16.7). These reports mirror those that need to be prepared for internal management purposes, and, therefore, should not involve any incremental report preparation time for the borrower.

16.8). These reporting requirements are to be included in the text of the Loan Agreement between the Facility and the MFI.

¹⁶ If the Stand-Alone Fund Alternative is adopted, the requirement for quarterly reports will apply only. Whereas the annual ratio analysis report will be required irregardless of the structure adopted.

SECTION 17. THE TREASURY FUNCTION:

17.1). Inherent to an institution that provides financing to borrowers on a revolving basis is the need for an effective Treasury function. Such a function will be needed for the Facility. The duties of the Treasury will include the following:

1. Manage the initial drawdown of funds from the original financiers of the Facility.
2. Manage the cash flow of the Facility so that there are adequate funds to meet the needs of both the borrowing MFIs on a timely basis, and to cover the ongoing operational expenses. This will require close co-ordination with the MFIs to assess their borrowing needs, and a reliable cash flow forecasting model.
3. Invest any surplus funds in short-term income earning investments, thereby maximizing the earnings of the Facility.
4. Maintain the appropriate accounting and record keeping system for the activities of the Treasury Department.
5. If and when lines of credit are established with the formal financial sector, manage the lines of credit with these creditor organizations.
6. Collaborate with management in the preparation of five- year business forecasts to project the future funding needs of the Facility.

17.2). Initially, the level of sophistication for the Treasury function will be modest, but as the Facility grows it will become increasingly complex. Because of this, it will be critical to ensure that the Manager of the Facility has a good understanding of cash flow management, and an effective cash flow forecasting model. For this reason the design of an appropriate cash flow forecasting model is identified as one of the next steps to be undertaken, if the decision is taken to go ahead with the Facility.

SECTION 18. AUDIT AND COMPLIANCE CRITERIA

Accounting and Reporting Criteria:

18.1). Regardless of the legal vehicle used for the establishment of the Facility; the books, records and financial reporting of the Facility will be prepared and maintained in accordance with the governing rules and regulations. If the Facility is established as a Fund, the governing law will be the Securities Act of 1998. If the elected structure is as a Limited Company, then the appropriate law will be the Companies Act of 1997. If an Offshore Trust is established, the governing law will be that of the host country, possibly Bahrain or Cyprus.

18.2). In all cases the accounting and reporting requirements will comply with the guidelines adopted by the major corporations and institutions within the Kingdom. These are the International Accounting Standards, which are published by the International Accounting Standards Committee. The accounting and reporting systems and published statements for the Facility will, therefore, comply with these standards.

18.3). Additionally, the Facility will comply with the Taxation Laws of Jordan, regarding the preparation of financial statements.

18.4). Since commingling the assets of the Facility with other assets under the direction of the Manager is barred; it is recommended that the Facility adopt the Fund Accounting concept. This entails the maintenance of separate accounting records for the Facility, and the preparation of a funds statement together with an income and cash flow statement.

Auditing Criteria:

18.5). It is proposed that the Facility be audited by a representative of one of the leading international auditing firms. In Jordan, the following international firms are represented:

Arthur Anderson (Allied Accountants)
Deloitte and Touche (Saba & Co)
PriceWaterhouseCoopers (Bawab & Co)
Whinney, Murray, Ernst & Ernst
KPMG Peat Marwick

18.6). The audit standards used by most of the leading auditing firms are the International Auditing Standards published by the International Auditing Standards Committee. The audit firm selected, and it is recommended that it be one of the above, will be required to undertake their audit procedures in accordance with these international standards, and will also provide a management

letter as part of their services. Also, it is recommended that the audit firm be recruited on an open tender basis for a two-year assignment. Thereafter, the contract would be re-tendered for a further two-year term.

Management Accounting and Reporting Criteria:

18.7). In the case where the devolution of the Facility to the MFIs option is utilized, the Facility will need to retain the services of a professional accounting firm to review the MFIs' performance compared to the terms and conditions of the Facility Agreement. The firm selected for this task should be drawn from the list of recommended auditors, as detailed above. The management reports that are to be prepared by the MFIs for review by the accounting firm, should include the following:

- (i). The annual business plan and updated financial projection.
- (ii). Quarterly reports, including the Fund Statement, Income and Expense Statement, and Cash Flow Statement. These statements should include comparative figures for the previous quarter, the comparative quarter from the preceding year and the current budget/forecast. These reports can be modeled on those in Appendix 4.
- (iii). Quarterly summary of financial ratios, including the ratios included in the SEEP ratio book.
- (iv). A quarterly summary on the details of the Loan Portfolio outstanding. This will include:

- An aging report
 - Details of the portfolio at risk
 - Details of loans due and unpaid.
 - Movements in the Loan Loss Reserve during the quarter.
 - A list of the ten largest loans
 - Loan portfolio concentration; by geographic region, purpose, and type of loan product.

- (v). A summary of the Facility's short term investments as of the close of the quarter.

18.8). The management accounting firm's duties will include reviewing and critiquing these reports, and summarizing their findings to the board/overseers of the Facility. These findings also will include recommendations either for improvement of the performance of the MFI, or advising what steps should be taken to protect the assets of the Facility, should it become necessary.

THE BUSINESS PLAN

SECTION 19, INTRODUCTION:

19.1). Based on the earlier discussions and conclusions about the establishment of the Facility, the following business plan has been prepared. The projection model has been designed in EXCEL and provides estimates for a five-year period. For year 1 the estimates are prepared on a quarterly basis, Year 2 is estimated on a six monthly basis, and Years 3-5 are forecast on an annual basis.

19.2). The projections themselves consist of the following documents:

- Balance Sheet
- Portfolio Funding Statement/ Cash Balance Statement
- Income and Expense Statement
- Summary of Movements in the Capital Account
- Capital Expenditures Budget.

19.3). The projection will be relevant regardless of the legal structure adopted for the Facility. Also, it will be functional whether an external manager is hired, or the Facility is established as an operating entity in its own right. It does, however assume that the transactions of the Facility will be accounted for on a stand-alone basis; preferably using a fund accounting system.

SECTION 20. BASIC PRINCIPLES FOR THE BUSINESS PLAN:

20.1). The business plan is based on the following assumptions:

- (i). That there will be sufficient funding available to establish the Facility in time to meet the financial requirements of the MFIs in the second half of calendar year 2000.
- (ii). The initial funding will be grant funding.
- (iii). There will be a maximum of six borrowers from the MFI.
- (iv). The management of the Facility will be sub-contracted to an existing financial institution.
- (v). The Manager will be employed on the Administrative Management model basis.
- (vi). AMIR's administrative costs for providing oversight for the Facility will be absorbed by AMIR itself.

SECTION 21. ASSUMPTIONS FOR PROJECTIONS

21.1). The attached projections are based on the following assumptions:

- Loan drawdowns are based on the funding requirements as outlined in Section 5, “Projected Demand for Financing from the Facility”.
- Since the capital is assumed to be granted to the Facility, the initial analysis is based on a nil cost of capital.
- The management fee will be based on the amount of total assets under management. The fee is set at 1.5% of total assets, and is calculated on the total assets at the end of the previous accounting period.
- The Loan Loss Reserve is calculated as 3% of the loan portfolio outstanding at the end of the accounting period.
- Initially, all clients will be classified as normal borrowers, and will be borrowing at the “normal” interest rate (11.5% for short-term loans, and 13.5% for long-term loans). Thereafter they will progress to being “prime clients”, and will borrow at the “prime” rates of 10.5% and 12.5%.
- The start-up costs for the Facility are established at 10,000 JD. These costs are to be borne by the Facility, and will mainly consist of training for the seconded personnel, legal costs, and minimal start-up capital costs for the Facility.
- Audit and other professional fees are being budgeted for at a rate of 10,000 JD per annum, inflation adjusted.
- All other operational and administrative costs are for the expense of the manager, and are included in his fee.

SECTION 22. FINANCIAL ANALYSIS OF THE FORECASTS:

22.1). Two scenarios of loan drawdowns by MFIs have been prepared.

- (i). This assumes that the MFIs will tap the Facility for the maximum amount of their funding requirements as outlined in Section 5, “Projected Demand for Financing from the Facility”, totaling 11,100,000 JD

- (ii). The funding requirements are 50% of those projected in (i) above, that is 5,568,000 JD.

Profitability:

22.2). Under both projections the Facility achieves profitability in the first six months of the second year of operations. Thereafter, the profitability of the Facility increases sharply, reaching the following statistics in Year 3-5.

	Scen. (i) Year 3	Scen. (i) Year 4	Scen. (i) Year 5	Scen. (ii) Year 3	Scen. (ii) Year 4	Scen. (ii) Year 5
Net Income To Revenue	73%	79%	85%	70%	78%	83%
Return on Sub. Capital	8.0%	9.0%	9.7%	6.7%	9.2%	10.1%
Return on Total Assets	6.0%	7.6%	7.6%	6.2%	7.8%	7.9%

22.3). The level of profitability is achieved by the zero cost of capital, which has been assumed for the Facility. If a cost of capital equivalent to the interest rate payable on the CBJ's Certificates of Deposit is charged (8.25%) to the granted capital, the results are as follows:

	Scen. (i) Year 3	Scen. (i) Year 4	Scen. (i) Year 5	Scen. (ii) Year 3	Scen. (ii) Year 4	Scen. (ii) Year 5
Net Income To Revenue	(1.9%)	6.9%	12.4%	(1.9%)	9.7%	15.2%
Return on Sub. Capital	(0.2%)	0.8%	1.1%	(0.2%)	1.2%	1.8%
Return on Total Assets	(0.2%)	0.6%	1.1%	(0.2%)	1.0%	1.4%

22.4). These figures indicate that, based on both assumptions, the Facility could afford to finance itself at the BOJ Certificate of Deposit rate, as long as it is acceptable to defer the break-even point until year 4 of the Facility. Furthermore, this projection highlights the impact the rapid build-up retained earnings have on the profitability of the Facility, since these would attract only a notional charge, as opposed to a "real" cost of funds.

Liquidity/ Capitalization Needs:

22.5). The projected high profitability also has a substantial positive impact on the liquidity/capitalization needs of the Facility. Both projection scenarios indicate that the amount of capital required to adequately finance the Facility is less than the anticipated loan usage by the MFIs.

(a). In scenario (i), usage is estimated to peak at approximately 11,100,000 JD, while only funding of 10,000,000 JD is required. In year five while usage is projected to ease a little, a surplus cash balance of almost 3,000,000 JD will surplus will have accumulated.

(b). In scenario (ii), usage is projected to crest in year 4 at approximately 5,600,000 JD. This can be funded by a capital subscription of 4,700,000 JD. As is the case in model (i), funds surplus to operational needs build up rapidly in year five, when 1,100,000 JD in cash will be available for short-term investments.

22.6). It needs to be borne in mind, however, that if there is a cost attached to the capital structure of the Facility, this will have an impact on the amount of capital that will be needed to finance the operations. If the Facility is expected to have a life span of much longer than five years with increasing usage, the amount of capital required to finance its operations will be substantially higher, since the level of retained earnings will be considerably lower, therefore necessitating more external capital.

22.7). This means that in planning the financing strategy for the Facility, there will be a trade-off between sourcing a smaller amount of capital on which no dividends or interest would be paid; or paying interest/ dividends on the capital, but requiring more of it.

Timing of the Capitalization:

22.8). Under both of the above-mentioned scenarios, the capital funding can be phased in over time. Funding will be required beginning in the third quarter of Year 1, and the largest capital inputs will be required in year 2 (3,900,000 JD in scenario (i), and 2,450,000 JD in scenario (ii)). Thereafter the incremental funding requirements decline considerably. This phased approach is constructive on two counts. Firstly it eases the funding requirements for potential donors, since they will not have to provide the funds in one large lump sum. Secondly, it enables the Facility to operate on a trial basis, so that if the facility is not operating effectively, or there is no demand for it, it can be shut down while only a limited amount of funding has been invested into it.

SECTION 23, SENSITIVITY ANALYSIS:

23.0). The following sensitivity analysis has been undertaken:

A Drop in the Demand for Loans:

23.1). The impact on the sustainability of the Facility has been measured at the following levels, on the following assumptions:

- (i). The analysis is based on year 3, when the Facility will be a mature operation.
- (ii). The loan loss provision is increased each year by 1% of the loan portfolio outstanding.
- (iii). A cost of capital, represented by either interest on debt or dividends on equity, is priced at the CBJ 6-month Certificate of Deposit rate of 8.25%.
- (iv). The management fee, and the other operational costs are unchanged.

Loan Demand	Income	Operat. Costs	Cost of Capital	Income
2,000,000 JD	235,000	74,000	165,000	(4,000)
6,000,000 JD	705,000	174,000	495,000	36,000
8,000,000 JD	940,000	224,000	660,000	56,000

23.2). This analysis indicates that if the loan demand only reaches 2,000,000 JD, the Facility more than covers its operational costs. At the 6,000,000 JD and 8,000,000 JD levels, the Facility is highly profitable.

23.3). If a cost of 8.25% is attached to the capital, and the loan demand does not exceed 2,000,000 JD on a continuous basis, the Facility will not be sustainable. Even at higher levels of usage, the net operating margin is thin.

A Drop in the Lending Rates:

23.4). A lowering of the interest rates charged on loans by the Facility of 1% has the following impact on the two scenarios.

Scenario (i). A 1% drop in the average interest rate charged on loan portfolio in year 3 reduces net income by 76,500 JD to 542,500 JD.

Scenario (ii). A 1% drop in the average interest rate charged in year 3 reduces net income by approximately 38,000 JD to 259,000 JD.

23.5). Under both scenarios the interest rate would have to drop by more than 7% for the profitability to be imperiled.

23.6). If the cost of funds of 8.25% is charged on the capital, under both Scenario (i) and Scenario (ii) the Facility is in a break-even position. Consequently, a 1% decrease in the average interest rate results in a loss in years 3 and 4, and only a small surplus in year 5.

An Increase in Management Fees:

23.7). The business plan assumes that the management fee will be based on 1.5% of the total assets of the Facility. Therefore a 1% increase in this fee to (an extremely expensive) 2.5% would have the following impact.

Scenario (i). Net income would decline by 103,000 JD to 516,000 JD.

Scenario (ii). Net income would fall by 48,000 JD to 249,000 JD.

23.8). If the contributed capital is costed at 8.5% per annum, the 1% increase in the management fee will cause a loss for the Facility under both scenarios for years 3 and 4, and a small surplus in year 5.

SECTION 24, RISKS:

24.1). The following risks have been identified:

The Projected Demand for the Facility does not Materialize:

24.2). The situation envisions the circumstances where the MFIs do not grow as rapidly as has been predicted, or they are able to source alternative capital at cheaper rates. In these circumstances the Facility could be deemed superfluous to the needs of the AMIR program. Should this occur, the closing down of the Facility will be greatly aided by the limited amount of capital that will have to be re-deployed, since the Facility will be funded on an as-needed basis. Moreover, a difficult personnel situation will not have arisen, since the management of the Facility is in the hands of an existing institution under a contract that will include an early termination clause.

24.3). This risk is considered manageable.

The Facility Incurs Large Credit Losses:

24.4). In the situation where the Facility is managed under the Accountable Management model, the Manager is responsible for a proportion of any losses. Having their own capital at risk will serve as a healthy incentive for them to operate on a prudent basis.

24.5). Under the Administrative model, the Manager will be operating under strict guidelines, and any problems that occur will be a result of the inappropriate guidelines, or the Manager breaching them. This situation will be controlled by close supervision via a system of monthly reports. Any problems that occur should be quickly apparent, and remedial action taken promptly.

24.6). Moreover, the Facility will establish a Loan Loss Reserve equal to 3% of the Loan portfolio outstanding. This should provide an adequate cushion against any deterioration in the loan portfolio quality.

Funding for the Facility does not Materialize:

24.7). Obtaining funding commitments has been identified as one of the critical issues that needs to be resolved before the Facility is established. If no funding is available at the outset, obviously the Facility will not proceed. The risk of funding drying up during the growth stages is the greater risk; since MFIs will be relying on the Facility to finance their own growth, and could be placed in a liquidity squeeze should funding not be available. The risk can be diminished by careful planning at the outset. The Facility will need to obtain clear commitments as to the timing and amount of future funding. Furthermore, a decision will have to be taken as to whether the initial capital will be funded by grants, with the associated rapid growth of internally generated funds, or if external investors will be invited to contribute equity.

24.8). In the long term, if the Facility can develop a performance record, and display that it can service external capital, professional investors could be approached about participation.

SECTION 25, SUMMARY AND CONCLUSION:

25.1). The results of this business plan indicate the following:

1. There appears to be a clear need for the Facility, although a better picture of the demand for its financial services will have to await updated business plans from the MFIs. Projections, however, have been prepared on a number of scenarios.
2. With an interest rate regime tied to the CBJ Re-discount rate, resulting in interest rates on the loans of 10.5%-13.5% per annum calculated on a reducing balance basis, the Facility covers all of its operational costs in the second half of year 2. This estimate is based on a minimum loan portfolio usage of 2,000,000JD a year. Greater usage of the Facility creates a linear increase in profitability, since costs are mainly tied to the growth of the assets of the Facility.

3. If a cost of capital is charged on the contributed capital, thereby acting as a proxy for debt or equity capital, the profitability of the Facility declines sharply. With a cost of capital of 8.25% (the interest rate on the CBJ 6 month Certificate of Deposit), the Facility does not breakeven until year 4 if the loan demand is less than 2,000,000 JD, and year 3 when loan usage is greater. Moreover, the profitability is thin as measured by the return on capital, which would be 0.6% on 6 million JD or 0.7% on 8 million JD.
4. Based on the above projections, the decision on how to finance the Facility could very well depend on what types of funders/ investors are sought, and how much funding is available. If funding is in the form of grant funding, much less capital will need to be committed since it will allow for the rapid build-up of retained earnings. On the other hand if debt or equity capital is required to fund the Facility, and it is priced at 8.25%, an incremental 2,750,000 JD under scenario (i) will be needed over a five year period if the facility is fully utilized.
5. If no cost of capital is paid (as opposed to a book charge) on the contributed capital, there will be a substantial cash balance available for short-term investments. This will require the introduction of an increasingly sophisticated investment strategy, and will further add to the profitability of the Facility.
6. The sensitivity analysis indicates that with a zero cost of funds, there is sufficient margin to cover any variations from the original projections without having a major negative impact on the profitability of the Facility. But if a cost of capital is charged, the margin of error becomes considerably tighter, and with a smaller capitalized Facility, it delays the break-even point until year 4.

SECTION 26. NEXT STEPS:

26.1). If the decision is taken to proceed with the establishment of the Facility, the following steps will need to be undertaken to ensure its smooth implementation.

- Clarify and quantify the source of funding for the Facility. The original premise was that the start-up funding would be sourced from USAID. This may no longer be the case. Funding for at least the first 12 months of loan demand from the MFIs of 1,250,000 JDs needs to be identified as a matter of urgency.
- A no objection notification needs to be obtained from the CBJ. The Supervisory Department of the CBJ was briefed about the possible creation of the Facility, and no objections were raised at that stage. A follow-up meeting needs to be held with them, however, and their no-objection obtained on a formal basis.
- The MFIs need to update their business plans, so that a current estimate of potential demand for loans from the Facility can be projected. Currently three of the four MFIs have stale business plans. Steps have been taken by AMIR to help them update their projections.
- Based on the updated business plans, firm projections should be prepared for the Facility. This will aid in quantifying the funding requirements of the Facility.
- Commence preparations to establish the legal entity for the Facility.
- Prepare the detailed performance criteria/job description and the Terms and Conditions for managing the Facility. These can be based on Sections 8 and 11 of this report.
- - Finalize the short list of potential Managers of the Facility, and circulate the job description and terms and conditions of the Management Contract. Request proposals from the candidates, including quotes for their fee scales.
- Select the accounting firm who will undertake the management and legal audits of the Manager. Consideration should be given to retaining their services to review the MIS and custody systems of the final candidate prior to awarding the contract.
- Select the Manager of the Facility
- Provide assistance to the Manager in establishing the required credit file system for the borrowers. Assistance for this task should be requested from the accounting firm.

- Prepare the necessary legal documentation for both the Management Contract and for the lending transactions with the MFIs.
- Design a cash flow forecasting model for the Facility.
- Establish the short-term investment criteria for the manager to follow.
- Establish and implement a training program in microfinance for those staff of the Manager who will be charged with managing the Facility.
- Commence negotiations with JLGC about their providing guarantees for the loans made to the MFIs by the Facility, and also for some of the larger loans made by the MFIs to their clients.
- A sunset strategy needs to be established for the Facility. If the facility is successful in its role of creating bridging finance to MFIs until they can access commercial financing in their own right, then plans need to be prepared for the role of the Facility and its assets when its financing services are no longer needed. One option might be for the Facility to make a capital investment in the MFIs, thereby changing its role from being a funder to being an investor.

Timing for the Establishment of the Facility:

26.2). Current indications are that the MFIs may need funding by the third quarter of calendar year 2000. With this deadline the timing for the necessary steps to be taken are as follows:

January 31, 2000:

This report to be completed.

The decision made as to whether or not to establish the Facility.

February 28, 2000:

Central Bank no-objection letter to be obtained.

Sources of funding to be identified and quantified.

March 31, 2000:

Legal Vehicle Established

April 30, 2000:

The Manager of the Facility selected

The Audit Firm selected.

Negotiate with JLGC about providing portfolio insurance.

The criteria for short term investments to be completed.

June 30, 2000.

The training of the Manager's staff to be completed.

Funding for the Facility to be available "at call".

APPENDIX 1

DOCUMENTS READ DURING THE COURSE OF THE CONSULTANCY:

NGO Assessment and Assessment of Bank Interest. *June 30, 1998.*

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APPENDIX 2

INDIVIDUALS INTERVIEWED DURING THE COURSE OF THE CONSULTANCY:

Ms. G. El-Khoury. *Director, Jordan Field Office, Save the Children Foundation.*
Mr. F. Sharaf. *Manager Investment Banking Unit, Export & Finance Bank.*
Mr. G. E. Abuyaghi, *General Manager, AMC.*
Ms. N. Sharaf. *Executive Director, JDWS.*
Ms. N.K. Batchoun, *Executive Manager, Central Bank of Jordan*
Dr. S-E. M. Al-Bashir, *Managing Partner, International Business Legal Partners*
Mr. S.H. Lughod, *Senior Partner, Arthur Anderson*
Mr. B. A. Baker, *Partner, Arthur Anderson*
Mr. A. P. Hadad, *Partner, Saba and Co (Deloitte & Touche)*
Mr. F.J. Bawab, *Senior Partner, Bawab & Co (PriceWaterhouseCoopers)*
Mr. S. Stephen, *Partner, Bawab & Co. (PriceWaterhouseCoopers)*
Mr. Q. Qataman, *Manager, JMCC*
Ms. N. Bseiso, *Office Manager, JMCC*
Mr. R. Jabba, *Country Director, CHF*
Mr. T. Al-Khateeb, *MIS Manager, CHF*
Dr. M. A. Waked, *Director General, Industrial Development Bank*
Mr. M. Al-Shaker, *Manager, Small Scale Industries and Development Fund, Industrial Development Bank.*
Mr. L. Shahzadeh, *Corporate Relationship Manager, HSBC Bank.*
Dr. M. S. Nabulsi, *Chairman and CEO, Jordan Investment Trust.*
Mr. Q. A. Abu-Qorah, *Assistant Director General, Jordan Investment Corporation.*
Dr. Z. Khalifeh, *Managing Director, Jordan Mortgage Refinance Co. Ltd.*
Ms. Z. Shahadeh, *Manager, Refinance Loan Dept. Jordan Mortgage Refinance Co. Ltd.*
Mr. A. Vermes, *Vice President, Marketing Head, Citibank.*
Dr. M. Salah, *Director General, JLGC.*
Mr. W. A. Zir, *Manager, Credit Guarantee Program, JLGC*
Mr. R. Fariz, *SPP Director, Ministry of Planning*
Mr. N. Shradih, *SPP-SMI Coordinator, Ministry of Planning*
Mr. J. D. Lindborg, *Director, Economic Opportunities Office, USAID*
Mr. G. Andersen, *Senior private Sector Advisor, Economic Opportunities Office, USAID*
Ms. R. Dababneh, *Project Management Specialist- Microenterprise, Economic Opportunities Office, USAID.*
Mr. S. Wade, *AMIR Program Director*
Mr. I. Alvizo, *AMIR Component Leader*
Ms. T. Kristalsky, *AMIR Deputy Component Leader.*
Mr. J. El-Wheidi, *Microfinance Specialist, AMIR.*
Dr. K. Elian, *Senior Economist, AMIR.*